

POST-COMMUNIST ENTERPRISE RESTRUCTURING
IN THE CZECH REPUBLIC : SEVEN CASE STUDIES

Helen Carter

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ABSTRACT

Voucher privatisation was designed to effect a rapid transformation of state-owned enterprises into private ownership with as limited state intervention as possible. Premised on neo-classical economic theory, the Czech government anticipated new private owners would emerge with greater incentives than the state to undertake restructuring and ensure the efficient operation of these firms. However, this thesis argues that for restructuring to occur, formal ownership patterns are less important than an ability to exercise control because of institutional influences. The *de jure* and *de facto* roles of owners, managers, and labour are discussed, showing how endogenous and exogenous factors affect their ability to dictate and control restructuring outcomes in voucher privatised firms.

The thesis argues that observed post-privatisation restructuring outcomes cannot be understood without considering the institutional environment within which firms are situated. Institutions are conceived to comprise formal, informal and enforcement aspects, but also with a temporal dimension encapsulated by the use of path-dependency and embeddedness. The explanatory framework offered here is a modified version of new institutionalism perspectives, termed “embedded institutionalism”.

Case studies of seven firms privatised by voucher are presented in this study to demonstrate how the interaction of institutional influences, understood through embedded institutionalism, is the most appropriate framework for understanding post-privatisation restructuring processes in post-communist countries. This approach

provides a synthesis between the theoretical expectations of neo-classical economic theory and the practical outworking of post-privatisation restructuring in Czech firms.

Voucher privatisation was a novel scheme, and became the central aspect of the Klaus government's economic transformation. Important historical and contemporary institutional influences impacted on its design and implementation. However, it is argued that understanding privatisation and its effects on restructuring through embedded institutionalism negates the view that a unique Czech way of privatisation exists, and that observed outcomes are simply responses to the surrounding institutional environment.

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I acknowledge receipt of a research grant from the University of St Andrews Russell Trust and a BASEES travel bursary towards the cost of the fieldwork expenses.

ACRONYMS AND GLOSSARY

ALMP	Active Labour Market Policy.
Assistent	Secondary school graduate unable to find a job, given a guaranteed, suitable position for one year by an employer receiving a subsidy equal to one year's wages from the government.
ČSKOS	Českomoravská Konfederace Odborových Svazů: Czech and Slovak Confederation of Trade Unions.
ČSSR	Československé Socialistické Republiky: Czechoslovak Socialist Republic.
DLO	District Labour Office.
IC	Investment Company.
IPF	Investment Privatisation Fund.
Konzern	Vertically linked group of state-owned enterprises.
KSC	Komunistická Strana Československa: Communist Party of Czechoslovakia.
NPF	National Property Fund.
Praktikant	University graduate unable to find a job, given a guaranteed, suitable position for one year by an employer receiving a subsidy equal to one year's wages from the government.
RHSD	Rada Hospodářské a Sociální Dohody České Republiky: Council for Economic and Social Accord.
RSDP	Rada pro Dialog Sociálních Partnerů České Republiky: Council for Dialogue between the Social Partners.
Trust	Horizontally linked group of state-owned enterprises.
UCS	Unemployment Compensation System.

CHAPTER ONE

INTRODUCTION

It is very easy to dismantle “explicit” socialism ... and to change some of the basic rules. But it is very difficult to dismantle the “implicit” socialism in us - the habits, prejudices and traditions built over the past decades in our political, social and economic system. The task as I understand it in my country, Czechoslovakia, is to create a normally functioning political system based on standard political parties. We have no wish to undertake new social experiments. We have had enough of such experiments in the past. ... We consider privatization to be a crucial precondition for the normal functioning of a market economy. ... This is the first basic pillar, the cornerstone of our reform strategy.¹

Following the Velvet Revolution of November 1989 that brought an end to Communist rule in Czechoslovakia, the country embarked upon a programme of reforms to move from central planning to a market economy. Setting privatisation as the central catalyst to the new government’s economic reforms exemplified a neo-classically inspired expectation that private owners would be more efficient than the state, and promote the desired economic growth during the post-communist reforms. This also, arguably, made the Czech reform distinct from reform strategies of other post-communist governments in the region where greater emphasis was placed on macroeconomic stability. However, this thesis does not support a conclusion that this

¹ Václav Klaus, ‘Transition: An Insider’s View’, *Problems of Communism*, 41 (1-2) (1992), 73-75, pp. 73-74.

indicates the existence of a unique Czech paradigm. Instead, it suggests that the policies of the Czech transformation, in particular privatisation, exhibit a rational response to the prevailing institutional environment, and that their design and appropriateness can only be appreciated by reference to this. Case studies are used to illustrate this conclusion in the study, and unlike neo-classical economics, validate the relevance of institutional influences on actually occurring restructuring.

Neo-classical economic theory guided the initial design of the Czech voucher privatisation programme, but restructuring outcomes manifested in formerly state-owned Czech enterprises appear to have diverged from those predicted. In this study, neo-classical economic theory is not regarded as adequate to predict and explain the outcome of reforms in Central and Eastern European countries because these are not simply economic processes, but have socio-political aspects as well. The alternative theoretical foundation adopted for this research, as explained later, is derived from the institutionalist tradition, to account for this.

Early studies of voucher privatisation were constrained to consider the technical design and introduction of this programme,² but divergences in the outcomes from those anticipated now demands further study into the reasons why. This shift in emphasis is partly a consequence of time having elapsed since the Velvet Revolution, and implementation of the privatisation programme having been implemented. The need for such a shift in emphasis is partly a consequence of time having elapsed since

² See for example Patrick Bolton and Gérard Roland, 'Privatization Processes in Central and Eastern Europe', *Economic Policy* 15 (1992), 275-309; Joseph C. Brada, 'The Mechanics of the Voucher Plan in Czechoslovakia', *RFE/RL Research Report*, 1 (17) (24 April 1992), 42-45; Olivier Bouin, 'Privatization in Czechoslovakia', in *Constraints and Impacts of Privatization*, edited by V. V. Ramanadham (London: Routledge, 1993), pp. 115-138; Roman Frydman, Andrzej Rapaczunski, John

the Velvet Revolution, as well as the privatisation programme having been implemented. This research therefore concentrates on restructuring processes occurring within firms after privatisation. In particular, it undertakes to demonstrate how enterprise insiders are impacted and constrained by institutional influences specific to their firms. It finds resonance with similar studies that also note discrepancies between the theoretical expectations of privatisation outcomes from neo-classical economic theory, and those seen in firms in transforming economies,³ but has a more holistic approach. Rather than analysing a particular concept to determine how it relates to post-privatisation restructuring, this work considers empirically observed outcomes, and derives from these the various influences that give rise to them.

Stimuli to restructuring in this study are conceptualised broadly, and their impact in multiple spheres, which may be competing or overlapping, considered. This avoids a simplistic specification of the causes and mechanisms of restructuring after privatisation in former state-owned enterprises. With the changing institutional environment within which these firms operate in transformation, it is essential to develop a framework that can account for the historic and contemporary factors that

S. Earle *et al*, *The Privatization Process in Central Europe*, Central European University Privatization Reports, 1 (Budapest: Central European University Press, 1993).

³ This approach appears in studies such as Michal Mejstřík, 'The Restructuring After Privatization in the Czech Republic', *Prague Economic Papers*, 8 (1999), 233-260; Jiří Večerník, 'Capitalist Renewal: Privatization and Business', in *Ten Years of Building Capitalism: Czech Society After 1989*, edited by Jiří Večerník and Petr Matějů (Praha: Academia, 1999), pp. 70-93. Two notable studies that have adopted this approach but with a narrow focus on managerial influences on restructuring are Ed Clark, and Anna Soulsby, *Organizational Change in Post-Communist Europe. Management and Transformation in the Czech Republic*, (London: Routledge, 1999); Roderick Martin, *Transforming Management in Central and Eastern Europe* (Oxford: Oxford University Press, 1999). Similarly, but taking their point of reference as networks and ties, works include Gerald A. McDermott, 'Renegotiating the Ties that Bind: The Limits of Privatization in the Czech Republic', in *Restructuring Networks in Post-Socialism: Legacies, Linkages and Localities*, edited by Gernot Grabher and David Stark (Oxford: Oxford University Press, 1997), pp. 70-106; David Stark and László Bruszt, *Postsocialist Pathways: Transforming Politics and Property in East Central Europe*, (Cambridge: Cambridge University Press, 1998).

dictate the changes seen. As perceptions over the nature and influence of these are, to some extent, subjective, it is also essential to have a balanced assessment of how these are perceived within the firm. Consequently, the case studies here include respondents from through the employment hierarchy to achieve this.

The conventional use of institutionalism in studying aspects of transformation⁴ is extended by this work that is not only considering the influence of the past on current changes,⁵ but explicitly recognising influences from the contemporary environment simultaneously. Observed restructuring in privatised, former state-owned enterprises indicates that both elements interact, and that these need to be reconciled when modelling change processes. Embedded institutionalism is therefore developed in this study as the analytical framework to understand the restructuring measures adopted after voucher privatisation in Czech enterprises, which draws on institutional theory in preference to neo-classical economics.⁶ Despite the neo-liberal rhetoric of Klaus that attributed priority to market forces in privatisation and restructuring in accordance

⁴ As exemplified by work such as Antoni Z Kaminski and Piotr Strzalkowski, 'Strategies of Institutional Change in Central and Eastern European Economies', in *Institutional Change: Theory and Empirical Findings*, edited by Sven-Erik Sjöstrand (Armonk: Sharpe, 1993), pp. 139-150; Paul Aligica, 'The Institutionalists' Take on Transition', *Transition*, 3 (4) (1997), 46-49.

⁵ Examples of works that consider historical influences through path-dependency on contemporary transformation outcomes through path-dependency include Douglass C. North, 'Transaction Costs, Institutions and Economic History', in *The New Institutional Economics: A Collection of Articles from the Journal of Institutional and Theoretical Economics*, edited by Eirik G. Furubotn and Rudolf Richter (Tübingen: Mohr, 1991), pp. 203-213; Adam Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America*, Studies in Rationality and Social Change, edited by Jon Elster and Michael S. McPherson (Cambridge: Cambridge University Press, 1991); David Stark, 'Path Dependency and Privatization Strategies in East Central Europe', *East European Politics and Societies*, 6 (1992), 17-54; Bruno Dallago, 'Between Spontaneity and Economic Engineering: Path Dependence in the Process of Economic Transition', in *Economic Developments and Reforms in Cooperation Partner Countries: The Social and Human Dimension*, edited by Reiner Weichardt, Colloquium 1996 (Brussels: NATO Economic Directorate and Office of Information, 1997), pp. 73-86.

⁶ Douglass C. North, *The Contribution of the New Institutional Economics to an Understanding of the Transition Problem*, WIDER Annual Lecture, 1 (Helsinki: United Nations University/WIDER, 1997); Geoffrey M. Hodgson, 'The Approach of Institutional Economics', *Journal of Economic Literature*, 36 (1998), 166-192; Anil Hira and Ron Hira, 'The New Institutionalism: Contradictory Notions of Change', *American Journal of Economics and Sociology*, 59 (2) (2000), 267-282. Expanded Academic ASAP International Edition. 7 December 2000. <<http://infotrac.galegroup.com/itweb/stand>>, [n.p.].

with neo-classical economics, it is shown that in practice institutional influences impacted upon the design and outcomes of the privatisation programme as a reform strategy. This has implications for the outcomes and overall effectiveness of the Czech privatisation programme, as it is ineffective if adequate incentives for sustainable and appropriate restructuring of enterprises do not arise from it.⁷

Following a review of the specific restructuring issues that this thesis addresses in its analysis of the incentives of enterprise insiders to implement such changes given the institutional environment within which privatisation and restructuring occur, an overall summary of the thesis is presented. This shows how the concept of embedded institutionalism is developed throughout this study, as a framework for conceptualising the environment within which privatisation and restructuring occur and respond to generate the results now visible. A brief review is then given of the companies studied, from which empirical evidence to illustrate the discussion of actually observed restructuring is generated.

This chapter then turns to consider the construct of embedded institutionalism in more detail, defining institutions as composite of formal, informal, and enforcement aspects, showing the importance placed on the informal and enforcement elements in this work. A crucial aspect of embedded institutionalism is that historical and contemporary conditions are both accounted for as positively creating institutional constraints on change through path-dependency and embeddedness respectively, and so the influence of each of these constructs on embedded institutionalism is discussed.

⁷ Nikolaos T. Milonas, *Mass Privatization Methods and their Effects on Capital Market Institutions, Agency Relationships and Managerial Monitoring*, Working Paper, 50 (Leuven: LICOS Centre for Transition Economics, 1995), p. 7.

Finally the chapter draws together the implications of path-dependency and embeddedness in embedded institutionalism to illustrate the difference between transition and transformation paradigms, showing that transformation is the preferred concept for describing the Czech reform process in this study, because path-dependency and embeddedness are integral to this perspective.

The particular focus of the thesis is on the response of, and interactions between, enterprise insiders; owners, managers, and workers, to the actually existing institutional environment within which they operate, in order to understand enterprise level restructuring responses that follow voucher privatisation of formerly state-owned Czech enterprises. Interviewees' responses from case studies of seven firms are used to illustrate and develop an explanation for observed restructuring processes. By setting this empirical evidence against theoretical Western economic orthodoxy, divergences between outcomes and theory are made apparent, suggesting that neo-classical economic theory is not valid for predicting restructuring outcomes in formerly state-owned enterprises under conditions of transformation in the Czech Republic. It is then argued that these disparities at the enterprise level arise because of institutional influences that impact on these in reality, implying difficulties with Klaus's desire for privatisation to be the cornerstone of reforms. The stress on institutional influences through embedded institutionalism to explain distinct, observed restructuring outcomes, it is also argued, negates the view that a specific Czech path of privatisation and restructuring exists. Instead, embedded institutionalism provides an alternative explanation for how and why restructuring of Czech enterprises has not fulfilled the expectations raised by neo-classical economic models, independent of the component elements of the post-communist reform

process, by identifying the existence of potential institutional influences and the manner in which these interact in reality.

The basic premise for understanding restructuring that is held in this work is consistent with emergent institutionalism perspectives that perceive existing structures, norms, and behaviours to dictate the potential and actual behaviour of actors in response to change.⁸ Empirical evidence from the case study firms is used in conjunction with institutionalism within this work to illustrate and understand restructuring processes within privatised Czech enterprises, and from this the empirical framework of the study is developed. New institutionalism theory is the foundational premise for this research, providing an alternative starting point to neo-classical economics. It is not intended however that this study details the implications of institutionalism theories, but rather situates itself within this broad tradition in preference to that of neo-classical economic theory because of its eclectic, inclusive conception of behavioural patterns and institutional influences from the surrounding environment. Specifically, strands from new social and economic institutionalisms are incorporated into embedded institutionalism. This diverges from the main approaches to new institutionalism by incorporating aspects from the political, economic and sociological institutionalisms because the factors that will interact and the extent to which any institutional conditions dominate in this thesis are not seen as determinable *a priori*.⁹ Embedded institutionalism therefore sets the focus of this study on the issues of path-dependency and embeddedness, ensuring that this work is

⁸ Jan Vlášil, 'Information About the Research', in *Politics, Skills and Industrial Restructuring*, Institute of Sociology Working Paper: 8, edited by J. Vlášil, I. Hradecká, I. Mazálková and G. McDermott (Prague: Academy of Sciences of the Czech Republic, 1996), pp. 5-17, p. 5.

⁹ Peter A Hall and Rosemary C. R. Taylor, 'Political Science and the Three New Institutionalisms', *Political Studies*, 44 (1996), 936-957.

sympathetic to perspectives that view transformation as a product of a broad mix of historical as well as contemporary economic, political, and socio-cultural conditions.¹⁰

This study gives an intertemporal, dynamic analysis of the privatisation process, and specifically endogenous restructuring processes in Czech enterprises. This study is therefore situated within the literature that views the post-communist reform process as an evolutionary transformation, rather than a transition with an overall blueprint to change and defined end point of the reform. As outlined below, two chapters are dedicated to the historical background of Czechoslovakia and the Czech Republic, and by implication those now involved in implementing privatisation and restructuring, as well as to understanding the theoretical basis for the entire Czech privatisation programme as an element of the country's overall post-communist reform programme. Discussion of potential tensions between historical and contemporary institutional influences is continued throughout the thesis, because the dynamic and even contradictory influences facing those implementing restructuring within enterprises need to be identified in order to understand observed outcomes to restructuring processes. As economic systems and societies develop and mature, so the relative importance of goals shifts in response to the altered institutional environment. For enterprises in particular, this means that the success of their restructuring depends on its appropriateness to the prevailing conditions that will change over time. Whilst definable in part by economic criteria such as sustainable production and profits, there can also be satisficing conditions of either an economic

¹⁰ See for example Karl Polanyi, *The Great Transformation: The Political and Economic Origins of Our Time* (Boston: Beacon Press, 1957); David Stark, 'Path Dependency', pp. 17-54; Douglass C. North, *Institutions, Industrial Change and Economic Performance*, Political Economy of Institutions and Decisions (Cambridge: Cambridge University Press, 1994); Douglass C. North, *The Contribution of the New Institutional Economics to an Understanding of the Transition Problem* (Helsinki: United Nations University/WIDER, 1997); David Stark and László Bruszt, *Postsocialist Pathways*; Douglass

or non-economic nature that managers and owners aim to meet in the operation of their firms. The effectiveness of a firm's restructuring strategy in this work is thus accorded to the wider context within which changes introduced and their appropriateness to their wider environment.

Until the end of 1992, the Czech and Slovak Republics existed as one political entity. Crucial to the post-communist history of Czechoslovakia has been that the differing histories, politics, and society of the Czechs and Slovaks generated important differences in the impact of Communism and the subsequent post-communist transformation in both lands.¹¹ Despite constant efforts to create a "Czechoslovak" nation and identity from 1918, this was never fully realised, and the Velvet Divorce in 1992 became inevitable once the political will to maintain this structure was lost. Most significant for this study is that although what are now two separate countries share much of their history, they also differ in a number of important respects over the perception, detail, and impact of these legacies. Also, the political leaders of these two countries had different objectives for their post-communist development, as evidenced for example by the second wave of voucher privatisation only occurring in the Czech Republic. For the period from 1993, this study therefore focuses only on policy and its effects in the Czech Republic.

Since the privatisation programme under consideration has operated in Czechoslovakia and the Czech Republic, the use of terminology has to be clarified. Czechoslovakia is used as a generic term to cover all of the country's historical

C. North, *Understanding the Process of Economic Change*, Occasional Paper, 106 (London: IEA, 1999).

territorial boundaries until the secession of the Slovak Republic, and the Czech Republic is used subsequently. In the post-communist era, for policies instigated in Czechoslovakia before 1993 and continued in the Czech Republic, reference is only made to the Czech Republic unless this is not evident from the context. The illustrative examples presented here are all of firms located in the Czech Republic, for only here did the privatisation programme designed for Czechoslovakia continue according to its original conception after the Czech and Slovak Republics became independent states on January 1 1993.¹²

1.1 OVERVIEW OF THE THESIS.

The extent to which privatisation is helping to create enterprises that are viable in a market economy and whether they are being restructured in ways that break the legacy of their Communist past and catalyse economic revitalisation of the Czech economy is reviewed throughout the rest of this work. Asset divestiture in the large-scale programme was mainly accomplished through a scheme of mass privatisation by voucher that “was untested and considered radical”¹³ at its inception, and was formally concluded in 1995. This study, through an assessment of the institutional environment within which the process has been occurring, is a reconsideration of the outcomes of this privatisation programme in light of its aim to not simply transfer property into private ownership, but to be the cornerstone of Klaus’ reforms.

¹¹ Sharon L. Wolchik, ‘The Politics of Transition and the Break-Up of Czechoslovakia’, in *The End of Czechoslovakia*, edited by Jiří Musil (Budapest: Central European University Press, 1995), pp. 225-244, pp. 238, 240.

¹² Dallago, ‘Between Spontaneity’, p. 82.

¹³ John S. Earle and Scott G. Gehlbach, *Privatization Policy Design and Popular Support for Reform in the Czech Republic*, 5th Nobel Symposium in Economics – The Economics of Transition, 10-12

An institutional perspective termed “embedded institutionalism” provides the methodological foundation for the discussion of institutional influences and their impacts in subsequent chapters. Inspired by, but distinct from neo-institutionalism, embedded institutionalism develops neo-institutionalism by explicitly accounting for historical and contemporary institutional influences through the notions of path-dependency and embeddedness. The underlying behavioural model incorporates socio-political and socio-economic aspects because an eclectic approach is assumed to provide the most appropriate framework for understanding restructuring processes for Czech companies. A fuller explanation of the construction and application of embedded institutionalism in this work is given later in section 1.2.

Potential constraints on the extent of restructuring firms undertake exist because all transactions occur within established spheres of exchange, and are conditioned by the norms and values that prevail within each one.¹⁴ This chapter demonstrates that the analysis of these will be made using embedded institutionalism. In the remainder of this work particular institutional influences relating to the design, organisation, and implementation of privatisation and subsequent restructuring are presented and assessed, so the thesis proceeds as follows.

September 1999 (Stockholm: SITE, 1999). 3 October 2000.

<<http://www.hhs.se/site/Publications/No141web.pdf>>, p. 8

¹⁴ Gunnar Myrdal, *Political and Institutional Economics*, (Dublin: Economic and Social Research Institute, 1978), p. 10; North, *Structure and Change*, pp. 5, 11; Ed Clark and Anna Soulsby, ‘Transforming Former State Enterprises in the Czech Republic’, *Organization Studies*, 16 (1995), 215-242, p. 216; Grandori and Soda, *Inter-Firm Networks*, pp. 190-191; W. Richard Scott, *Institutions and Organizations*, (Thousand Oaks: Sage, 1995), p. 151; Jens Beckert, ‘What is Sociological About Economic Sociology? Uncertainty and the Embeddedness of Economic Action’, *Theory and Society*, 25 (1996), 803-840, p. 829; Carol Slappendel, ‘Perspectives on Innovation in Organizations’, *Organization Studies*, 17 (1996), 107-129, p. 123; Peter Clark, *Organisations in Action: Competition Between Contexts* (London: Routledge, 2000), p. 164.

Institutional influences are intertemporal, so Chapter Two demonstrates the unique legacies and conditions under which the transformation began to provide the context for the reform strategy adopted. From this discussion it is shown that the transformation reflects both historical legacies as well as the prevailing conditions into which reforms are introduced. Understanding restructuring in Czech enterprises has to account for legacies from the past in formal structures as well as mentalities and expectations of the role of firms and employment in society. In the case studies, respondents frequently comment on how the contemporary situation differs from the past, and in some instances there is little evidence that these changes are accepted or embraced.

In Chapter Three, the main focus is on voucher privatisation since this is the main and novel element of the Czech programme, and the privatisation technique used by each of the firms in the case studies. This chapter shows that neo-classical privatisation theory is inadequate to explain the processes of property transfers and subsequent restructuring processes in Czech firms after voucher privatisation. Ways in which the design and implementation of the privatisation programme have been influenced by the institutional environment into which it was applied, in particular the underdeveloped character of institutions that prevented a mass privatisation programme of the type previously adopted in some developed market economies from being introduced, are shown. As the outcomes of the privatisation programme are only fully understood by reference to empirical evidence, the impressions of respondents of how this programme operated are given in this chapter to show how it is perceived in reality in its operation.

In keeping with the neo-liberal justifications for privatisation and restructuring, Klaus intended owner-driven restructuring following privatisation, rather than state-led restructuring before privatisation.¹⁵ It was expected that this would generate a new set of incentives for the management to focus on efficiency in production, so the following three chapters address the issue of whether adequate incentives to restructure exist for actors with interests in voucher privatised enterprises. These chapters are illustrated extensively with the impressions of respondents to show where there are differences between theory and reality. These are consistently derived from path-dependency and embeddedness to institutional influences and in particular, the retained mentalities and informal behavioural institutions of agents involved in change.

By considering the development of corporate governance mechanisms and shareholder protection in Chapter Four, the incentives to restructure their firms facing different owners is reviewed. Bank and market-based corporate governance systems are explained, but the forms of corporate governance emerging in Czech enterprises does not seem to correlate with either of these archetypes because of institutional conditions arising from voucher privatisation. Corporate governance mechanisms in Czech enterprises are often incomplete, so it is shown that *de jure* shareholdings here

¹⁵ Václav Klaus, *Ekonomická Věda a Ekonomická Reforma. Statě, Eseje* (Praha: Gennex & TOP Agency, 1991), p. 230; Frydman *et al*, *Privatization Process*, p. 70; Thomas W. Hazlett, 'The Czech Miracle: Why Privatization Went Right in the Czech Republic', *Reason*, 26 (11) (1995), 28-35. Academic Search Elite. EBSCO Publishing. 17 June 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; John Child with André P. Czeglédy, 'Managerial Learning in the Transformation of Eastern Europe', *Organization Studies*, 17 (1996), 167-179, p. 170; John C. Coffee, 'Institutional Investors in Transitional Economies: Lessons from the Czech Experience', in *Corporate Governance in Central Europe and Russia, 1: Banks, Funds and Foreign Investors*, edited by Roman Frydman, Cheryl W. Gray and Andrzej Rapaczynski (Budapest: Central European Press, 1996), pp. 111-186, p. 120; Ariane Hegewisch, Chris Brewster and Josef Koubek, 'Different Roads: Changes in Industrial and Employee Relations in the Czech Republic and East Germany Since 1989', *Industrial Relations Journal* 27, (1996), 50-64, p. 52; Philippe Aghion and Olivier J. Blanchard, 'On Privatization Methods in Eastern Europe and their Implications', *Economics of Transition*, 6 (1998), 87-99, p. 88.

do not necessarily correlate with *de facto* control. After voucher privatisation, owners often do not have the ability, or incentive, to restructure their firms, with effective control instead passing to the incumbent management. Chapter Five considers whether, from a restructuring perspective, this is a positive development within firms. It is argued that corporate governance mechanisms are weak and do not fully constrain managers in voucher privatised firms from acting in their own interests, but that managers remain influenced by other institutional factors. The experiences and expectations of managers from the period of central planning are shown to be strong institutional influences on the restructuring measures they introduce, where new patterns of behaviour are only adopted if there are expected gains to the managers from change.

However, the implementation of these measures within firms is also dependent upon their being embraced and adopted by workers. Labour is therefore considered in Chapter Six as another aspect of the institutional environment that determines whether desired restructuring occurs following privatisation. This is studied in the context of labour markets and the industrial relations structure, showing that there are incentives facing labour to adapt to change desired by the management and owners that influence the restructuring outcomes in firms. These also represent an institutional limitation determining the types of change managers and owners can introduce by defining the feasible range of restructuring measures that impact on labour. Another important aspect is that a unique phenomenon in the Czech transformation has been the low rates of unemployment, and so the chapter also considers whether this corresponds with low levels of restructuring after privatisation, arguing that there are conflicting institutional influences that determine these aggregate levels. Therefore,

assessing whether restructuring is occurring can only be achieved from empirical evidence derived from individual enterprises.

The final chapter summarises the implications of the embedded institutionalism approach, and considers whether a Czech paradigm exists for the privatisation and restructuring of enterprises. Although the Czech voucher privatisation programme was a novel scheme uniquely adapted to its context, it is proposed that understanding its outcomes through an institutional framework rather than with a neo-classical economic perspective shows that the uniqueness arises from the existence of these institutional influences, rather than because the Czech transformation is inherently distinct from that of other Central and Eastern European countries. Whilst the Czech transformation experience could not be transplanted directly into another country and the same outcomes ensue, this chapter argues that this thesis demonstrates the need for an institutional approach to understand the design, implementation and interpretation of reforms is required if an effective transformation strategy, that permits sustainable long-term development of the economy, is to be designed and its outcomes understood.

As explaining observed outcomes is central to this work, the theoretical aspect is supplemented by empirical findings from a complementary research project undertaken in seven Czech companies between February and September 2000. Located in Moravia, all are involved in light engineering and machine production. State-owned enterprises until 1989, each was subsequently transformed into a joint-stock company and privatised in the first wave of voucher privatisation. Empirical data on the processes and motivations behind enterprise restructuring was gained from

these case studies. It is then used to illustrate how the impact of institutions, as conceptualised through embedded institutionalism, can be used to explain the restructuring processes observed for privatised Czech companies.

1.2 PRESENTATION OF THE EMPIRICAL RESEARCH PROJECT.

The seven companies used for the case studies are intended to provide illustrative examples of restructuring processes and outcomes after voucher privatisation in Czech firms, as well as to illustrate the impact of institutional development on these. The manufacturing sector was selected because this is a well-established industrial branch in Moravia that has proved itself durable under the increasingly competitive environment of the transformation. The specific choice of companies was then determined by a number of criteria. As well as having been privatised by voucher, it was desired that the initial post-privatisation ownership was predominately by Czech individuals and firms. This was seen as important because the study is concerned with identifying as far as possible the domestic response to the altered institutional environment offered by the transformation. In firms that had been acquired by foreign owners, it is expected that these would be subject to the aims of the new owner. As these would not necessarily equate with those of Czech firms seeking to adapt and survive under the altered domestic conditions, the effects of direct foreign investment and ownership are outwith the remit of this study.

An element of comparability between the firms within their industrial branch was also sought. Four of the companies are now owned by one overall owner, Obchodní Cesta. Comparability between the companies in this group come from their shared

overall ownership structure, as well as tight links between the present-day firms arising from their having all been members of two *konzern* during communism. Likewise, two other firms, Brodchmel and Císař, were part of the same *konzern* during most of their communist era production. Although the output of both firms is very similar, the restructuring strategies and overall success of these distinct enterprises is very different. Subsequent chapters argue that this is a direct consequence of their particular institutional environment. The final company studied, Drazitest, provides a contrast to these other two groups of firms, having been a large state-owned enterprise that has undergone dramatic downsizing and restructuring with privatisation, but which is the core of the original state-owned enterprise that has retained many of its staff and assets. The final selection of companies of course reflects an important pragmatic consideration, namely the willingness of appropriate companies to participate in the study.

Table 1.1 provides a summary comparison of the major features of the companies studied, and further details of the companies follow. Specific information on the interview methodology and the respondents are given in Appendix 3.

Table 1.1: Summary of Companies Studied.

		Rukopis Strojiny	Rozdat Systems	Odras KM	Přesnost KM
Business Area	2001	Commercial reproduction machinery.	Industrial measuring and distribution machinery.	Commercial cutting machinery.	Electronic and precision engineering tools.
Ownership	2001	78%: Obchodní Cesta. Remainder held by individuals.	Obchodní Cesta through parent Rukopis Strojiny.	Obchodní Cesta through parent Rukopis Strojiny.	42%: Obchodní Cesta. 6%: IPFs, 3%: NPF. Remainder held by individuals.
Structure	2001	Holding company with 2 daughters.	Daughter company of Rukopis Strojiny.	Daughter company of Rukopis Strojiny.	Joint-stock company. 2 branch plants and 1 co-operation production plant.
Employees	1989	> 2 000	> 500	800	5 500
	1999	1 233	370	550	1 934
Turnover Million Kč	1999	1 505	727	282	671
Markets	2001	Western Europe, Central Europe North America, South America, Asia.	Central and Eastern Europe, Middle East, Asia.	Europe, USA, Asia	Europe, USA, Japan.
Information Flows and Decision Making	2001	Flows through long company hierarchy. Determined by ISO 9001 norms.	Determined by ISO 9001 norms in Rozdat Systems. Barriers to communicating with Rukopis Strojiny.	Effective within Odras KM. Often by-pass Rukopis Strojiny to deal directly with Obchodní Cesta.	Some structural barriers to communication, but generally effective.
Prognosis for the future:		Strong product base and foreign distribution network.	Actively seeking new strategic investor, likely to bring needed restructuring.	More unemployment necessary. Facing strong competition globally.	Further co-operation production likely and necessary to sustain revenue and employment.

		Drazitest	Císař	Brodchmel
Business Area	2001	Exploratory and construction engineering.	Precision metalworking.	Precision metalworking.
Ownership	2001	18%: IPF. 39% held by 3 Directors. Remaining shares held by company employees.	47%: Němec - German financial consortium. Remaining shares held by IPFs and individuals.	Majority ownership by banks and IPFs. Remainder held by individuals.
Structure	2001	Joint-stock company. Branch plants in 4 locations.	Holding company with 4 daughters.	Joint-stock company.
Employees	1989	1 600	> 10 000	3 000
	1999	170	1 230	2 264
Turnover Million Kč	1999	272	510	972
Markets	2001	Czech Republic.	Germany, North America, South America, Africa, Asia, Australia.	Central and Eastern Europe, USA, Middle East.
Information Flows and Decision Making	2001	Hierarchical, but effective. Determined by ISO 9001 norms.	Very little information passed between owners, managers and employees.	Strong barriers to communication between owners, managers and employees.
Prognosis for the future:		Progressive firm competing on quality, not price, but with strong competition in Czech markets.	Declining firm. Very uncertain future. More unemployment and capital investment essential.	Seeking product diversification and new strategic owner. More unemployment necessary.

1.2.1 Rukopis Strojírny, Přesnost KM, Rozdat Systems and Odraz KM.

Four companies in the study, Rukopis Strojírny, Rozdat Systems, Odraz KM, and Přesnost KM existed before privatisation as two state-owned enterprises, Rukopis Strojírny and Přesnost KM.¹⁶ Each of these companies are involved in machinery manufacture, the Rukopis Strojírny group producing machinery for various industrial and commercial processing tasks, and Přesnost KM producing precision engineering tools and electronic engineering products.

Rozdat Systems and Odraz KM came into existence as fully-owned subsidiaries of the Rukopis Strojírny state-owned enterprise in 1993, previously having been two divisions of this state-owned enterprise. Both had product lines distinct from that of Rukopis Strojírny before 1993 and were operating at separate locations, with these operations continued by the new companies.

Created through strategic restructuring processes, Rozdat Systems was originally separated from Rukopis Strojírny when a foreign investor expressed an interest in purchasing this production unit. Whilst the sale did not complete, Rozdat Systems remained a subsidiary of Rukopis Strojírny, although an alternative, preferably foreign, buyer is still actively sought by the management teams of both companies.

Rukopis Strojírny and Rozdat Systems are located in a small community 15 km outside the nearest large town, Petrov. Although the communication network to Petrov is poor, this location was chosen for political reasons as there is no other

industry in this community. The company provided housing, an apprentice school, and a cultural centre in the town for the employees and their families.

Odraž KM and Přesnost KM are situated a further 10 km away in the medium-sized town of Karstněsto, which has three main industrial employers. As a result, Odraž KM and Přesnost KM are less tightly integrated into their local communities and their employees do not identify with their company to the same extent as those in Rukopis Strojírny and Rozdat Systems.

Interdependences still exist between the companies, with some of Rozdat Systems and Odraž KM's output produced for Rukopis Strojírny, their parent company. The directors of the daughter companies resent this constraint to varying degrees though, as the daughter companies both desire as much independence as possible within this organisational structure. Linkages also extend to their ownership structure, with all of the companies of the Rukopis Strojírny group ultimately owned by Obchodní Cesta, a company based in Prague that has a 78% ownership stake in Rukopis Strojírny. Additionally, Rukopis Strojírny owns 42% of the shares of Přesnost KM.

1.2.2 Císař.

Císař is one of a number of large employers in Petrov. Established to produce for the defence sector, it has undergone a number of shifts in its primary production from this to agricultural machinery and office equipment. Production now centres on fulfilling

¹⁶ Company names and locations have been changed to protect confidentiality and uphold this agreed condition of access.

commercial defence and security contracts. Císař had over 70 production locations at its peak in the 1930s. Plant closures after privatisation led to a centralisation of production at the company's main plant in Petrov, although much of this remains unoccupied and unused, and its workforce has now shrunk to around 1,230. Very little investment has been made into physical capital at the plant, with most of the production machinery around 30 years old and the buildings between 70 and 100 years old. The structure of the workforce is heavily skewed, with the average age of employees 58 years, the majority of whom are skilled but narrowly focused technicians.

Economically, the company is struggling for its continued survival, the combined result of disadvantages in the company's physical and human capital resources and the ownership and management strategies in the firm. Following its establishment as an independent firm apart from the Císař *konzern* in 1989 and privatisation in 1992, the company adopted a new holding structure in July 2000, with each of the four production divisions transformed into wholly-owned subsidiaries operating from the site in Petrov. This change came following the purchase of the firm by a German financial consortium that already owns several other privatised Czech factories involved in a variety of manufacturing processes. These structural changes were designed to rationalise the economic management of the firm and to decentralise decision-making to the particular business area. The effectiveness of this restructuring has not yet been quantified within the firm because of the small amount of time that has elapsed since its introduction. However, the extent of structural difficulties within the firm are potentially so great as to preclude any effective long-term restructuring.

1.2.3 *Brodchmel.*

Brodchmel was also part of the same *konzern* as Císař until 1983 when it was incorporated into an agricultural producers *konzern*. In 1988 it became an independent state-owned enterprise, reverting to its original name that has been retained subsequent to privatisation. Producing similar products to Císař, it differs by also manufacturing complementary tools and parts, as well as offering servicing and advice on its product range.

Located about 50 km away from Petrov in a predominately rural region, Brodchmel is one of two dominant employers in its locality. Consequently it is very tightly linked to the local community, both as an employer, and through the provision of cultural and social services to the local population. The closure in the early 1990s of two of its three plants in the town had a devastating effect on employment in the region, which was already above average because of limited alternative employment opportunities in other industries or agriculture. Changing from state to private financing of the firm has also resulted in a reduction of company sponsorship for community activities. That this has contributed to a worsening relationship between the enterprise and the local community is felt strongly by employees at all levels in the corporate hierarchy.

Over 70% of the firm's shares are held by 13 investment privatisation funds (IPFs), but only two of these have holdings in excess of 10%. Nonetheless, these are clearly definable owners, and so the management is limited in its ability to exercise *de facto* control in decision-making. The main problem faced by the firm appears to be

barriers to communication between the owners, management and employees that significantly hinder effective restructuring.

1.2.4 Drazitest.

Drazitest is the smallest company in the study, employing around 179 people, although it was formerly the core of a state-owned enterprise bearing the same name and with over 1,000 employees. Its business area is exploration and construction engineering. Drazitest is located on the outskirts of Petrov, and was historically the largest employer in the district. Upon privatisation, the Drazitest state-owned enterprise was divided into five separate companies along the lines of the five main, but distinct, business functions of the company. Today Drazitest occupies only the main building of the original plant and other small industries have been established in the vicinity, so Drazitest has lost some its dominance in the locality. Previously a monopoly in Moravia, it now has to compete for contracts against a number of smaller firms offering similar services throughout the Czech Republic. Many of these competitors were established by former employees of Drazitest.

Drazitest was the only part of the former Drazitest state-owned enterprise to be privatised by voucher. Most of the shares of the company were bought by employees, primarily in the hands of three directors, each with 14%. One investment privatisation fund has an 18% ownership stake but its practical influence on the operation of the firm is negligible. The way in which voucher privatisation has been effected in Drazitest, bringing tight co-operation between the owners and employees, is viewed very positively throughout the firm.

1.3 EMBEDDED INSTITUTIONALISM.

According to neo-classical economic theory, compared to state ownership, greater efficiency results from private ownership. This is because private owners are assumed to have incentives to ensure profit maximisation since they personally bear the costs of economic inefficiency. Whilst modelling a frictionless, competitive environment may be assumed to provide a close approximation to the economic systems in developed market economies, this is not valid for transformational economies with underdeveloped institutions. An alternative understanding of how privatisation and restructuring processes occur under these conditions therefore needs to be developed, which is achieved by this work.

It is argued in this study that ownership does not necessarily correlate with control in newly privatised firms in the Czech Republic, and that formal and informal institutions interact and determine the outcomes of privatisation and restructuring within enterprises. This study demonstrates the influence of these institutions on observed restructuring processes, temporally and spatially. Consequently, an institutional approach is regarded as more legitimate than a neo-classical economic explanation for discerning their existence and impact. The analytical framework developed to capture the intertemporal dimension of institutions and their influence on restructuring, as well as on the behaviour of the actors introducing restructuring in this study, is embedded institutionalism. Formal justification for using embedded institutionalism to assess the impact of institutional influences on visible outcomes by reference to the interaction between internal company restructuring and the external environment that result from voucher privatisation is presented here.

As no formal institutionalised structure from the previous system could re-assert its authority once political change had begun in Central and Eastern Europe, reformers faced an institutional *tabula rasa*¹⁷ with regard to tangible structures, but the neo-classical axiom of an institutional void cannot be assumed. Institutions here are defined as “humanly devised constraints that shape human interaction”,¹⁸ so any attempts to identify Czech approaches to privatisation and restructuring necessitates a consideration of the full range of this institutional environment. Institutions in this study are not only important in determining and limiting the range of potential outcomes. Since they incorporate formal structures, informal behaviour, and legitimacy and enforcement aspects,¹⁹ in many cases existing institutions will reflect their Communist heritage in structure, function, and legitimacy, and so may be incompatible with the prevailing conditions.²⁰

The extent of both formal and informal institutions in this study is seen as a constraint on restructuring that prevents outcomes as predicted by neo-classical economics from occurring. Formal institutional influences should not be neglected, but this study suggests that their influence within the transformation environment may be less significant than that of informal institutions. Insufficient time has elapsed for the emergence of all the necessary ancillary institutions of capitalism, and the absence of

¹⁷ Jon Elster, Claus Offe, Ulrich K. Preuss with Frank Boenker, Ulrike Goetting and Friedbert W. Rueb, *Institutional Design in Post-Communist Societies: Rebuilding the Ship at Sea*, (Cambridge: Cambridge University Press, 1998), p. 25.

¹⁸ Douglass C. North, *Institutions*, p. 1.

¹⁹ Douglass C. North, ‘Transaction Costs, Institutions and Economic History’, in *The New Institutional Economics: A Collection of Articles from the Journal of Institutional and Theoretical Economics*, edited by Eirik G. Furubotn and Rudolf Richter (Tübingen: Mohr, 1991), pp. 203-213, p. 204; Carola M. Frege and András Tóth, ‘Institutions Matter: Union Solidarity in Hungary and East Germany’, *British Journal of Industrial Relations*, 37 (1999), 117-140, pp. 117-118.

²⁰ Vaclav Klaus, ‘Monetary Policy in Czechoslovakia in the 1970s and 1980s and the Nature and Problems of the Current Economic Reform’, *Communist Economies*, 2 (1990), 61-71, p. 67; Irene McMaster, *Privatisation and Transformation in the Czech Republic 1989-1997*, Unpublished PhD thesis, Department of Government, University of Strathclyde, 2000, p. 131.

some can preclude the emergence of others.²¹ A simple imitation of the structures existing in the West is unlikely to result in the emergence of an optimal set of institutions, but allowing institutions to evolve and become embedded and valid within the Czech economy will take time.²² Whether established *de novo* or adapted from previous institutions, formal structures are liable to only have limited effectiveness in the initial transformation period because of incongruence with their surroundings.²³ Even when institutions exist, ensuring that they function effectively is also an issue to be resolved,²⁴ for

[m]any Czech institutions looked like their market economy counterparts, but they do not operate in the same way. Institutional effectiveness in a market economy depends not only on the institutions themselves but also on their interactions with the business environment and their know-how. Flaws in the operation of financial institutions, capital markets, and the legal system visited hardships on many Czech companies and made their process of change more difficult.²⁵

²¹ Richard R. Nelson, 'Recent Evolutionary Theorizing About Economic Change', *Journal of Economic Literature*, 33 (1995), 48-90, p. 82; Claus Offe, 'Designing Institutions in East European Transitions' in *The Theory of Institutional Design*, edited by Robert E. Goodin (Cambridge: Cambridge University Press, 1996), pp. 199-226, pp. 216, 217.

²² J. Mencinger, 'Lessons from the Transition Process', *Empirica*, 20 (1993), 189-204, p. 199; Mark Casson, 'Enterprise Culture and Institutional Change in Eastern Europe', in *The Economies of Change in East and Central Europe: Its Impact on International Business*, edited by Peter J. Buckley and Pervez N. Ghawi (London: Academic Press, 1994), pp. 33-53, p. 51; Roman Frydman and Andrzej Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away?*, (Budapest: Central European University Press, 1994), pp. 64-65.

²³ Jan Winiecki, *Political Economy of Reform and Change: A Case of Eastern Europe* (New York: Nova Science, 1997), p. 130.

²⁴ Hans J. Blommestein, Rainer Geiger and Paul G. Hare, 'Privatising Large Enterprises: Overview of the Issues and Case Studies', in *Methods of Privatising Large Enterprises* (Paris: OECD/CCEET, 1993), 11-37, p. 20; Jozef M. van Brabant, *The Political Economy of Transition: Coming to Grips with History and Methodology* (London: Routledge, 1998), p. 250; Anderson Consulting, *Reconnecting Europe: Towards a Common Future* (1999). 4 August 2000.

<http://www.ac.com/ideas/perspect/show_p6r2sect5.html>, [n.p.].

Informal institutions are therefore important as these can determine acceptable norms and standards of behaviour, and as a result influence the nature of formal institutions that will emerge in time.²⁶ Privatisation, through the changes it implies in ownership and control structures, should be a strong institutional catalyst to organisational restructuring, yet precisely because those with the ability to effect change may also be those with the strongest interests to perpetuate the former system, inertia may arise within the emerging system.²⁷ In keeping with current work on institutionalism, it is contended in this thesis that understanding restructuring demands a consideration of intangible factors such as the networks of power and influence that were developed under the old regime to circumvent some of the idiosyncrasies of the planned economy and how these remain influential and can be mobilised in the current time.²⁸ Behavioural patterns are "sticky" in the pace at which they can change because they are path-dependent, and also self-reinforcing, so this problem cannot be overcome simply by the passage of time. The entire culture in which individuals operate needs

²⁵ Karen L. Newman and Stanley D. Nollen, *Managing Radical Organizational Change* (Thousand Oaks: Sage, 1998), p. 22.

²⁶ Jens Blom-Hansen, 'A 'New Institutional' Perspective on Policy Networks', *Public Administration*, 75 (1997), 669-693, p. 682; Martin Raiser, *Informal Institutions, Social Capital and Economic Transition: Reflections on a Neglected Dimension*, Working Paper 25 (London: EBRD, 1997), p. 1. Ákos Róna-Tas and József Böröcz, *The Formation of New Business Elites in Bulgaria, the Czech Republic, Hungary and Poland: Continuity and Change, Pre-Communist and Communist Legacies*, Working Paper (San Diego: Graduate School of International Relations and Pacific Studies, University of California, 1999), [n.p.].

²⁷ Arthur L. Stinchcombe, 'Social Structure and Organizations', in *Handbook of Organizations*, edited by James G. March (Chicago: Rand McNally, 1965), pp. 142-193, p. 161; Stewart Ranson, Bob Hinings and Royston Greenwood, 'The Structuring of Organizational Structures', *Administrative Science Quarterly*, 25 (1980), 1-17, p. 7; Roman Frydman and Andrzej Rapaczynski, *Privatization and Corporate Governance in Eastern Europe: Can a Market Economy be Designed?*, Economic Research Reports, 52, C. V. Starr Center for Applied Economics (New York: Department of Economics, New York University, 1991), p. 29; North, *Institutions*, p. 68.

²⁸ Jan Winiecki 'Obstacles to Economic Reform of Socialism: A Property Rights Approach', *Annals of the American Academy of Political and Social Science*, 50 (Special Issue) (1990), 65-71, p. 65; Gernot Grabher and David Stark, 'Organizing Diversity: Evolutionary Theory, Network Analysis, and Post-socialism', in *Restructuring Networks in Post-Socialism: Legacies, Linkages and Localities*, edited by Gernot Grabher and David Stark (Oxford: Oxford University Press, 1997), pp. 1-32, p. 8; Avner Greif, 'Cultural Beliefs and the Organization of Society: A Historical and Theoretical Reflection on Collectivist and Individualist Societies', in *The New Institutionalism in Sociology*, edited by Mary C. Brinton and Victor Nee (New York: Russell Sage Foundation, 1998), pp. 77-104, p. 79.

to be altered in former socialist countries,²⁹ with profound changes in institutions as well as regulation and behavioural patterns required.³⁰

To provide a more accurate model of restructuring processes and the motivation driving change, embedded institutionalism has to overcome the limitations of neo-classical economic models by considering institutional influences on behaviour.

Neither the *homo-economicus* model from an economic institutionalism approach where individuals are assumed to act only in the pursuit of rational self-interest, or sociological institutionalism that conceives individuals acting as *homo sociologicus* with reference to culturally determined norms,³¹ are taken in this work to be appropriate conceptualisations of the behaviour of actors involved in post-privatisation restructuring in Czech firms. Instead, convergence between these is sought by incorporating aspects of both perspectives. Following emerging institutionalism approaches, individuals are understood to act as *homo socio-economicus*, responding to both economic and social influences when taking decisions.³² In this study, therefore, no institutional influences are *a priori* perceived to have greater legitimacy in explaining given outcomes, with all of the impressions

²⁹ Andrzej K. Kozminski, *Catching Up? Organizational and Management Change in the Ex-Socialist Block* (Albany: State University of New York, 1993), pp. 2, 148; A. D. Jankowicz, 'The New Journey to Jerusalem: Mission and Meaning in the Managerial Crusade to Eastern Europe', *Organization Studies*, 15 (1994), 479-507, p. 483; Douglass C. North, *Contribution of the New Institutional Economics*, p. 17; Ed Clark and Anna Soulsby, *Organizational Change in Post-Communist Europe. Management and Transformation in the Czech Republic* (London: Routledge, 1999), p. 178; Róna-Tas and Böröcz, *Formation of New Business Elites*, [n.p.].

³⁰ Václav Klaus, *Renaissance: The Rebirth of Liberty in the Heart of Europe* (Washington: Cato Institute, 1997), p. 9; Demetrius S. Iatridis, 'A Global Approach to Privatization', in *Privatization in Central and Eastern Europe: Perspectives and Approaches*, edited by Demetrius S. Iatridis and June Gary Hopps (Westport: Praeger, 1998), pp. 3-25, p. 16; Markéta Šumpiková, 'Vlastnictví a Výkon Vlastnických Práv a Povinnosti', *Acta Oeconomica Pragensia*, 5 (5) (1997), 25-52, pp. 31, 32.

³¹ Blom-Hansen, 'A 'New Institutional' Perspective', p. 674.

³² Siegwart Lindenberg, 'A New Push in the Theory of Organization: A Commentary on O. E. Williamson's Comparison of Alternative Approaches to Economic Organization', in *The New Institutional Economics: A Collection of Articles from the Journal of Institutional and Theoretical Economics*, edited by Eirik G. Furubotn and Rudolf Richter (Tübingen: Mohr, 1991), pp. 115-123, pp. 116, 117, 127.

and experiences of respondents assumed to be potentially influential on change. The embedded institutionalism approach consequently accounts for the impact of stochastic processes that do not have predictable influences on policy decisions and outcomes³³ because of its inclusiveness regarding the source and influence of institutions.

Understanding privatisation and restructuring in enterprises now occurring has to refer to the country's past history as well as the contemporary environment, since both determine the conditions under which changes occur, impinging upon the policies implemented and on their outcomes.³⁴ This necessitates an approach that accounts for the current observed outcomes as a product of complex and interconnected actions from the past and present. For assessing privatisation, this involves placing visible restructuring processes within enterprises as central and reflecting organisational reality, and from this, attempting to isolate the influences and motives that have resulted in these outcomes. Embedded institutionalism in this work gives primacy to path-dependency and embeddedness in understanding institutional influences, explaining both inertia and dynamism in organisational structures by differentiating institutional influences over time and space.³⁵

³³ Paul A. David, 'Clio and the Economics of QWERTY', *American Economic Review*, 75 (2) (1985), 332-337, p. 332.

³⁴ Michael W. Peng, *Business Strategies in Transition Economies* (Thousand Oaks: Sage, 2000), pp. 14, 16.

³⁵ Mark Granovetter, 'Economic Actors and Social Structures: The Problem of Embeddedness', *American Journal of Sociology*, 3 (1985), 481-510, p. 490; Gernot Grabher, 'Rediscovering the Social in the Economics of Interfirm Networks', in *The Embedded Firm: On the Socio-Economics of Industrial Networks*, edited by Gernot Grabher (London: Routledge, 1994), pp. 1-31, p. 4; Anna Grandori and Giuseppe Soda, 'Inter-firm Networks: Antecedents, Mechanisms and Forms', *Organization Studies*, 16 (1995), 183-214, pp. 190-191; Brian Uzzi, 'Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness', *Administrative Science Quarterly*, 42 (1997), 35-67, pp. 35, 36.

1.3.1 Path-dependency and Embeddedness.

“Path-dependency” refers to the idea that previously learned behaviour and historical experiences may influence, either positively or negatively, choices made in the present, as well as setting reforms on a trajectory that becomes increasingly difficult to alter as interests converge around a given reality.³⁶ Institutionalism perspectives revolve around path-dependency since “[t]oday’s “institutions” almost always show strong connections with yesterday’s, and often those of a century ago, or earlier”.³⁷ Nonetheless, a pitfall that should be avoided with path-dependency is that of placing an incorrect weight on the role of history in analysis, for it is not a straightforward deterministic concept that dictates a certain finishing point because of the existence of specific conditions. Additionally, legacies from more recent periods do not necessarily impinge upon and condition economic and political thought in the immediate post-Communist period more intensely than earlier historical legacies as

[t]here is much remaining in Eastern Europe of political traditions dating from the interwar period and earlier, including elements of authoritarianism, bureaucratic dominance and intense nationalism [and] these countercultures had by the mid-1980s achieved an impressive degree of autonomy.³⁸

³⁶ Douglass C. North, ‘A Transaction Cost Approach to the Historical Development of Politics and Economies’, in *The New Institutional Economics: A Collection of Articles from the Journal of Institutional and Theoretical Economics*, edited by Eirik G. Furubotn and Rudolf Richter (Tübingen: Mohr, 1991), pp. 253-260, p. 259; David Stark, ‘Path Dependency’, p. 20.

³⁷ Nelson, ‘Recent Evolutionary Theorizing’, p. 82; North similarly expresses this idea. “Institutions are a set of rules, compliance procedures, and moral and ethical behavioural norms designed to constrain the behavior of individuals in the interests of maximizing the wealth or utility of principals ... [and though] ... some constraints are common to all societies ... others are specific to the interests of principals in different contextual settings.” Douglass C. North, *Structure and Change in Economic History* (New York: Norton, 1981), pp. 201-202, 203.

Moving from central planning to a market economy is not “replacing the state-centred model with a society-centred approach”,³⁹ but rather is “a complex reworking of old social relations in the light of distinct processes ... to construct a form of capitalism on and with the ruins of the communist system”.⁴⁰ Understanding the shift from central planning to a market economy necessitates consideration of the socio-cultural environment, and not just visible economic and political obstacles that have to be surmounted.⁴¹ There are “differing paths of extrication from state socialism that shape the possibilities of transformation in the subsequent stage”.⁴² Consequently, path-dependency needs to be incorporated into an explanation of the design, implementation and outcome of policies of transformation because these build upon the resources remaining from the old system.

Explaining restructuring processes in Czech privatised enterprises requires a path-dependent element to be incorporated because multiple legacies with intertemporal aspects exist that influence restructuring strategies at the enterprise level.⁴³ To account for path-dependency in enterprise restructuring, the conditions prevailing before privatisation and restructuring occur need to be identified to facilitate an appreciation of the nature of change according to the motives and factors contributing

³⁸ Thomas A. Baylis, *The West and Eastern Europe: Economic Statecraft and Political Change*, Twentieth Century Fund Book (Westport: Praeger, 1994), p. 19.

³⁹ Kazimierz Z. Poznanski, *Poland's Protracted Transition: Institutional Change and Economic Growth 1970-1994* (Cambridge: Cambridge University Press, 1996), p. 77.

⁴⁰ Adrian Smith and John Pickles, 'Introduction: Theorising Transition and the Political Economy of the Transformation', in *Theorising Transition: The Political Economy of Post-Communist Transformations* edited by John Pickles and Adrian Smith (London: Routledge, 1998), pp. 1-22, p. 2.

⁴¹ Edmund Mokrzycki, 'Eastern Europe After Communism', *Telos*, 90 (1991), 129-136. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

⁴² Stark, 'Path Dependency', p. 20.

⁴³ Károly Balaton, *Management in Different Phases of Organizational Transformation in Hungary*, International Workshop on Transition and Enterprise Restructuring in Eastern Europe, 20-22 August 1998 (Copenhagen: CEES/Copenhagen Business School, 1998). 25 September 2000. <<http://www.econ.cbs.dk/cees/institutes/cees/workshop/pdf/Balaton.pdf>>, [n.p.].

to their implementation.⁴⁴ Accumulated resources will not necessarily be appropriate for the new conditions, and the actual and perceived range of available policy choices may now be limited because of decisions taken in the past or prevailing conditions.⁴⁵ Former elites will be instrumental in implementing and participating in the transformation, and this can be problematic if it reduces the perceived legitimacy of the reform measures or restricts the effectiveness of measures implemented, because previous behavioural patterns persist and are not superseded or re-learned.

Historical contexts are partially responsible for contemporary outcomes as well as helping to determine the potential range of future choices.⁴⁶ As a corollary, the contemporary environment generates institutional influences that can modify and negate these influences, as well as creating new incentives and patterns of behaviour, as explained by embeddedness. The concept of embeddedness employed here extends Polanyi's expression of this⁴⁷ by having a path-dependent and contemporary aspect. In this study, because the contemporary external environment, as well as the character of actors undertaking restructuring influence the nature and effects of restructuring in privatising enterprises, embeddedness is understood to comprise "structural" as well

⁴⁴ Dallago, 'Between Spontaneity', pp. 76-77; Peng, *Business Strategies*, pp. 14-16.

⁴⁵ David F. Good, 'The Economic Transformation of Central and Eastern Europe in Historical Perspective', in *Economic Transformation in East and Central Europe: Legacies from the Past and Policies for the Future*, edited by David F. Good (London: Routledge, 1994), pp. 3-24, p. 4; North, *Institutions*, pp. 6, 99; Dallago, 'Between Spontaneity', pp. 73-74, 83.

⁴⁶ Grabher, 'Rediscovering the Social', pp. 1-31, pp. 4-5; Peng, *Business Strategies*, pp. 14, 16.

⁴⁷ "The market pattern [...] is capable of creating a specific institution, namely, the market. Ultimately, that is why the control of the economic system by the market is of overwhelming consequence to the whole organization of society: it means no less than the running of society as an adjunct to the market. Instead of economy being embedded in social relations social relations are embedded in the economic system. The vital importance of the economic factor to the existence of society precludes any other result. For once the economic systems is organized in separate institutions, based on specific motives and conferring a special status, society must be shaped in such a manner as to allow that system to function according to its own laws. This is the meaning of the familiar assertion that a market economy can function only in a market society." Polanyi, *The Great Transformation*, p. 57.

as “interpersonal” aspects.⁴⁸ “Interpersonal” embeddedness refers to how the behaviour and expectations of individual actors links enterprises with their surroundings and history. “Structural” embeddedness considers how organisations reflect their institutional environment in their formal structures after privatisation, as well as the influence of institutions on the extent of change and feasible restructuring measures that can be introduced. There is considerable overlap between these aspects of institutions though, since their influences are not fully divisible,⁴⁹ so a formal distinction between these aspects is not made in the discussion of embeddedness in the following chapters.

Despite former state-owned enterprises having operated under similar historical conditions and now sharing the same macro-economic and political environments, considerable diversity is observed in the restructuring processes of Czech firms. Embedded institutionalism explains this diversity by using the perspective of institutionalism that focuses on the particular linkages a firm develops in this shared institutional environment.⁵⁰ As enterprise restructuring is understood as one element within the overall post-communist economic reform process, the use of embedded institutionalism to evaluate enterprise restructuring has implications for how these wider economic changes are understood. Path-dependency and embeddedness influence the trajectory of reform because there are institutional influences on the component parts. This dictates the need to conceptualise each of these processes in a

⁴⁸ Richard Whitley, ‘The Internationalization of Firms and Markets: Its Significance and Institutional Structuring’, *Organization*, 1 (1994), 101-124, p. 109.

⁴⁹ North, ‘Transaction Costs’, p. 204; Frege and Tóth, ‘Institutions Matter’, pp. 117-118.

⁵⁰ Vedat Milor, ‘Changing Political Economies: An Introduction’, in *Changing Political Economies: Privatization in Post-Communist and Reforming Communist States*, edited by Vedat Milor (Boulder: Lynne Rienner, 1994), pp. 1-23, p. 17; Royston Greenwood and C. R. Hinings, ‘Understanding Radical Organizational Change: Bringing Together the Old and the New Institutionalism’, *Academy of Management Review*, 21 (1996), 1022-1054, pp. 1023, 1025, 1026-1027, 1032; Gunnar Eliasson, ‘From Plan to Markets’, *Journal of Economic Behavior and Organization*, 34 (1998), 49-68, p. 50.

comparable manner, so the section below considers which paradigm should be used to understand post-communist reform processes.

1.4 TRANSITION OR TRANSFORMATION?

Post-communist reform has increasingly been recognised by policy-makers in the region as a multifaceted process, encompassing a number of overlapping areas. However, an understanding of the implications of path-dependency and embeddedness did not characterise the majority of the policies devised in the initial post-communist period. The rejection of socialism was widely thought to be so complete that the past would have little bearing on the newly emergent social, political, and economic structures.⁵¹ The socialist model that failed to deliver economic and political systems to rival those premised on capitalist principles was rejected in favour of democratic market economies that were seen as the only feasible foundation for emerging post-communist societies.⁵²

Guided predominantly by Western institutions and advisors, the new leaders in Central and Eastern Europe were encouraged to design and propose blueprints for reform in the early months after the collapse of communism when it was not thought that the former systems could, or should, be incorporated into the new economic,

⁵¹ Jan Adam, 'Transformation to a Market Economy in the Former Czechoslovakia', *Europe-Asia Studies*, 45 (1993), 627-645, p. 637; Herman W. Hoen, ' "Shock versus Gradualism" in Central Europe Reconsidered', *Comparative Economic Studies*, 38 (1) (1996), 1-19. Academic Search Elite. EBSCO Publishing. 17 June 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; Róna-Tas and Böröcz, *Formation of New Business Elites*, [n.p.].

⁵² Václav Klaus, *A Road to Market Economy: Selected Articles, Speeches and Lectures Held Abroad* (Prague: TOP Agency, 1991), p. 12; Ivan T. Berend, 'The Collapse of State Socialism: Causes and Consequences', in *Economic Transformation in East and Central Europe: Legacies from the Past and Policies for the Future*, edited by David F. Good (London: Routledge, 1994), pp. 75-92, p. 77.

social, and political structures being developed.⁵³ Assigning property rights and transferring formerly state-owned property to the private sector through privatisation was to be the means by which new economic opportunities were to be realised.⁵⁴ Following a transitory period of initial adjustment, it was suggested that the whole process would take two to three years, with price and trade liberalisation, currency convertibility, removal of subsidies, and privatisation bringing market-driven growth in the future.⁵⁵ This exemplifies the “transition paradigm” that assumes the end-point of the transition is not influenced by historical events but is fixed, or at least definable, so that divergences from the required reform trajectory can be measured and corrected.⁵⁶

In reality, the time required for implementing reform policies and for their effects to be seen has taken much longer than the transition approach suggested, with numerous unanticipated outcomes.⁵⁷ Looking at the failed attempts to impose paradigms of

⁵³ This approach is epitomised in the Balcerowicz Plan in Poland. The perspective of the chief external advisor on this programme is given in Jeffrey Sachs, *Poland's Jump to the Market Economy* (Cambridge, MA: MIT Press, 1994).

⁵⁴ Barrie Stevens, 'Prospects for Privatisation in OECD Countries', *National Westminster Quarterly Review*, August 1992, 2-22, p. 12; Barbara Fakin, *Financial Institutions, Enterprise Investment Behaviour and Industrial Restructuring in Transition Economies*, Working Paper, 44 (Leuven: LICOS Centre for Transition Economics, 1995), p. 7; Andrzej Wojtyna and Jerzy Hausner, 'Privatization as a Restructuring Device: Can it Substitute for Industrial Policy in the Transforming Economies? Some Lessons from Poland', *Journal of Socio-Economics*, 22 (4) (1993), 417-443. Academic Search Elite. EBSCO Publishing. 22 June 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

⁵⁵ Valtr Komárek, 'Czech and Slovak Federal Republic: A New Approach', in *Economic Transformation in Central Europe: A Progress Report*, edited by Richard Portes (London: CEPR, 1993), pp. 58-106, p. 62; Lajos Héthy, 'Central and Eastern Europe: Economic Transformation, Social Cohesion and Social Dialogue', in *Economic Developments and Reforms in Cooperation Partner Countries: The Social and Human Dimension*, edited by Reiner Weichardt (Brussels: NATO Economic Directorate and Office of Information, 1997), pp. 9-16, p. 9.

⁵⁶ Stark, 'Path Dependency', p. 18; John E. Tedstrom, 'Economic Developments and Reforms in Cooperation Partner Countries: The Social and Human Dimensions', in *Economic Developments and Reforms in Cooperation Partner Countries: The Social and Human Dimension*, edited by Reiner Weichardt (Brussels: NATO Economic Directorate and Office of Information, 1997), pp. 313-316, p. 313; Ákos Róna-Tas, 'Path-Dependence and Capital Theory: Sociology of the Post-Communist Economic Transformation', *East European Politics and Societies*, 12 (1998), 107-131, p. 116.

⁵⁷ Mokrzycki, 'Eastern Europe', [n.p.]; Sharon L. Wolchik, 'The Politics of Transition in Central Europe', *Problems of Post-Communism*, 42 (1) (1995), 35-40. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; Daniel Daianu, 'Judging Romania's Way in a Comparative Framework', in *Economic Developments and Reforms in*

transition in Central and Eastern Europe shows the validity of considering the past histories of countries in transformation in policy design and implementation. The initially optimistic projections for rapidly constructing functioning market economies that would mirror those of Western Europe showed theory and practice to be incongruent. Transition reformers accepted that institutions take time to build and function, but by stressing the withdrawal of bureaucratic control over the economy to enable market forces to act, implicitly embodied an incorrect expectation that the market could, in an embryonic form, function before institutions were consolidated.⁵⁸

By contrast is the “transformation paradigm” that recognises that there is a need for change but that such reforms do not have an agreed or definable end point, and account for past events as well as the contemporary setting in all spheres of change.⁵⁹ The literature on transformation stems from an awareness that no single transition blueprint can exist as all countries face unique conditions and difficulties in undertaking change.⁶⁰ Adaptations to the actually existing conditions have to be made to policy instruments if successful reforms are to occur.⁶¹ There is only a vague understanding of what a market economy in these countries will or should look like once it has been achieved. Since the trajectory of reform changes occurring in Central and Eastern Europe is seen to incorporate path-dependent and embeddedness aspects, the term “transformation” is adopted in this work in preference to “transition”. This acknowledges that there are differences between both perspectives, whilst also

Cooperation Partner Countries: The Social and Human Dimension, edited by Reiner Weichardt (Brussels: NATO Economic Directorate and Office of Information, 1997), pp. 241-260, p. 243.

⁵⁸ Sachs, *Poland's Jump*, p. xiii; Daianu, 'Judging Romania's Way', p. 246.

⁵⁹ Tedstrom, 'Economic Developments', p. 313; Róna-Tas, 'Path-Dependence', p. 116.

⁶⁰ Ralf Dahrendorf, *Reflections on the Revolution in Europe: In A Letter Intended to Have Been Sent to a Gentleman in Warsaw 1990* (London: Chatto and Windus, 1990), p. 60; Stephen E. Hanson, 'Analyzing Post-Communist Economic Change: A Review Essay', *East European Politics and Societies*, 12 (1998), 145-170, p. 167.

representing an appreciation that the transformation paradigm offers a more accurate description of the process in the Czech Republic. This is because accounting for the social and political setting in which economic change occurs allows a meaningful understanding of the changes underway and the best ways for them to be achieved.⁶²

In rhetoric at least, Klaus understood the validity and necessity of a transformation rather than a transition perspective on the reform process, likening the economic reform process in the Czech Republic to a game of chess where “[o]ne simply has to know how to play. One cannot know in advance the position on the chessboard after White’s 26th move.”⁶³ Subsequently he recognised that the reforms do not occur within a vacuum, but instead are constrained by, and must adapt to, legacies of the past, stating that

we cannot isolate the present from history. For all our preoccupation with the difficult transformation tasks and challenges, it would be wrong and misleading to interpret our situation as a total discontinuity. ... We should neither demonize nor trivialize nor belittle [the past].⁶⁴

Of direct relevance to this work is whether Klaus understood or responded to the implications of this distinction in the design of the privatisation programme. Klaus desired the re-creation of a market economy to help overcome the negative economic

⁶¹ Ed Clark, ‘The Role of Social Capital in Developing Czech Private Business’, *Work, Employment and Society*, 14 (2000), 439-458, p. 440.

⁶² Herman W. Hoen, *The Transformation of Economic Systems in Central Europe* (Cheltenham: Elgar, 1998), pp. 19-20.

⁶³ Klaus, ‘Transition’, p. 75.

⁶⁴ Klaus, *Renaissance*, p. 34.

legacies of the Communist economic model,⁶⁵ but the influence of institutions that is critical in determining the outcomes appears to have been underestimated. The institutional environment prevented the privatisation programme generating the outcomes predicted by neo-classical economic theory that had provided the inspiration for Klaus' approach. Neo-classical expectations for privatisation and restructuring outcomes in transformational economies are shown in this thesis to be fundamentally flawed. This is because its premises are inappropriate because they do not take sufficient account of the presence and effects of institutions, which can be non-economic and have a temporal impact on currently observed outcomes.

If former state-owned enterprises are to be restructured so that they can operate efficiently apart from the centrally planned economy, institutional changes are needed. The most significant change for the Czech Republic, as discussed in this work, is the privatisation programme, being a formalised change in the institutional environment and a catalyst to future institutional development as the transformation progresses.⁶⁶ However, before looking at the appropriateness of privatisation in catalysing transformation overall, the following chapter presents a historical review of the development of Czechoslovakia and the Czech Republic to demonstrate the institutional context of the path-dependent and embedded aspects of the transformation from central planning to a market economy.

⁶⁵ Václav Klaus, *Česká Cesta*, p. 134.

⁶⁶ Milonas, *Mass Privatization Methods*, p. 7.

CHAPTER TWO

ESTABLISHMENT TO TRANSFORMATION

Communist rule in Czechoslovakia introduced central planning to the economy, representing a shift away from economic organisation according to market forces as had existed since 1918. From 1989 this trend began to be reversed with the collapse of the Communist regime and the election of a new government committed to establishing a democratic political and market economic system in its place. The formal dismantling of the previous system however is not the only necessary change for a successful transformation since informal and enforcement aspects of institutions persist over time and dictate the actual restructuring outcomes that occur. After 1989, reformers perceived communism to have been an aberration in the country's development, with transformation offering an opportunity to "return to Europe", but an institutional approach highlights the difficulty of achieving this because institutional influences preclude frictionless change. This chapter therefore considers the historical developments of Czechoslovakia and the Czech Republic to identify enduring institutional influences in the current transformation environment.

As discussed in the previous chapter, this thesis does not regard it possible to understand observed post-privatisation restructuring in enterprises without reference to historical legacies that are a combination of myth and reality, as well as institutions in the contemporary environment. Despite Klaus having claimed similarities in the transformation process with that of other post-communist countries,¹ seeking a Czech

¹ Václav Klaus, 'Main Obstacles to Rapid Economic Transformation in Eastern Europe: The Czechoslovak View', in *Towards a Market Economy in Central and Eastern Europe*, edited by Hebert

solution to transformation is shown to have a historical precedent in the “Czechoslovak way to socialism” of Beneš, and Dubček’s “socialism with a human face”.² This historical review therefore contextualises the discussion of institutional influences on restructuring in the current transformation. It also highlights the source of institutional influences that are specific to the Czech transformation, and that generate different empirical outcomes here compared to other countries in Central and Eastern Europe. This strengthens the justification for, and position of, embedded institutionalism taken in this work that holds that there is not a distinctive Czech paradigm of transformation, but only the rational response of firms and actors to their institutional environment.

In the first section below, an overarching description of the characteristics that relate to the emergence of Czechoslovakia and distinguish it from other countries of Central and Eastern Europe is given. This is then followed by the more detailed chronology of institutional influences in the pre-Communist and Communist periods that endure and can shape the current reform trajectory and policy outcomes because of the expectations and limits to change they generate. In the final section, the institutional nature of the post-communist transformation is presented. This chapter thus provides a foundation for understanding the institutional conditions to which privatisation in the Czech Republic had to respond and the institutional influences promoting observable restructuring outcomes that is discussed in the remaining chapters.

Giersch (Berlin: Springer-Verlag/Egon-Sohmen Foundation, 1991), pp. 77-91, pp. 85-87; Václav Klaus, *Renaissance: The Rebirth of Liberty in the Heart of Europe* (Washington: Cato Institute, 1997), p. 134.

² Alice Teichova, *The Czechoslovak Economy: 1914-1918* (London: Routledge, 1988), pp. 91-92.

2.1 THE CZECH REPUBLIC: A UNIQUE LEGACY.

The events of 1989 and the transformation that began in the aftermath of the Velvet Revolution were without precedent, yet some inverted parallels can be drawn with the introduction of Communist rule in Czechoslovakia in the 1940s. This had path-dependent and embedded aspects, with the interwar period in particular directly impacting upon the adoption and implementation of the socialist model. Most notable was Czechoslovakia's earlier commitment to democratic politics and its political and economic structures being comparable to those of developed countries of Western Europe until 1938. This intensified the impact of changes brought by the Soviet model because of its inherently contradictory nature in comparison to the country's democratic traditions.³

Czechoslovakia in the 1940s represents the sole incidence of Communist rule having been introduced by some form of democratic elections in Central and Eastern Europe. Finding some resonance with the ideals of the population at the time, only after the 1968 Soviet invasion did popular perception change to regard this as a foreign occupation.⁴ Amongst the satellite states in Central and Eastern Europe, Czechoslovakia was one of the closest adherents to the political and economic policies of the Soviet Union, with these links persisting in some form until the collapse of the Soviet bloc.⁵ Outside of the Soviet Union, Czechoslovakia was the

³ Sharon L. Wolchik, *Czechoslovakia in Transition: Politics, Economics and Society* (London: RIIA/Pinter, 1991), p. 21.

⁴ Jiří Brodský, 'Little Czechs, Big Europe', *Central Europe Review*, 2 (20) 22 May 2000. 26 May 2001. <<http://www.ce-review.org/00/20/brodsky20.html>>, [n.p.].

⁵ Bijan B. Agheuli, Eduardo Borensztein and Tessa van der Willigen, *Stabilisation and Structural Reform in the Czech and Slovak Federal Republic: First Stage*, Occasional Paper: 92 (Washington: IMF, 1992), p. 1; Carol Skalnik Leff, *The Czech and Slovak Republics: Nation versus State* (Boulder: Westview Press, 1997), p. 63-64; Ivan T. Berend, *Central and Eastern Europe 1944-1993: Detour from the Periphery to the Periphery* (Cambridge: Cambridge University Press, 1998), p. 146.

first country of the socialist bloc to receive the designation “socialist”, reflected in the changes to the Constitution in 1960. This was at the cost of declining living standards and a subsequent stagnation of economic growth in the early 1960s as the first manifestation of the failing of this model as an economic development strategy here.⁶ Nevertheless, Czechoslovakia maintained the advantages of its initial starting conditions throughout its Communist existence, with one of the highest recorded GNP rates amongst all the socialist bloc countries until 1989.⁷ The industrial legacy of a pre-war market economy based on capitalist principles in 1989 positively shaped the expectations of reformers and the wider population that re-introducing a market economy would be less problematic here than elsewhere in Central and Eastern Europe because of this precedent.⁸

To show the significance of path-dependency and embeddedness in the current transformation, the Czech Republic’s economic and political history is presented, with particular reference to major reform periods. Considering the country’s development from its formation as a sovereign state in 1918 until the post-Communist reform period encapsulates legacies of the pre-Communist and Communist pasts as well as contemporary conditions, without negating any important influences. Not only is the physical institutional legacy of the old order important, but also the inherited “norms” and behavioural patterns that appear entrenched.⁹ Accordingly, attention is given to macro-level conditions in social, political, and economic spheres as well as micro-

⁶ Rick Fawn, *Czech Republic: A Nation of Velvet*, Postcommunist States and Nations (Amsterdam: Harwood Academic Publishers, 2000), pp. 17, 18.

⁷ Leff, *Czech and Slovak Republics*, pp. 135, 136; Fawn, *Czech Republic*, p. 3.

⁸ Václav Klaus and Tomáš Ježek, ‘Social Criticism, False Liberalism and Recent Changes in Czechoslovakia’, *East European Politics and Societies*, 5 (1991), 26-40, pp. 30, 37-39; Jan Svenjar, ‘Introduction and Overview’, in *The Czech Republic and Economic Transition in Eastern Europe*, edited by Jan Svenjar (San Diego: Academic Press, 1995), pp. 1-19, pp. 2-3.

level factors in reform strategies such as individual rent-seeking behaviour and firm-level interactions.¹⁰ From a position of accepting the framework of embedded institutionalism, this work adopts an inclusive approach that identifies the three dimensions of institutions; formal, informal and enforcement, and their potential impact on decision-making and policy outcomes by either constraining or catalysing change.

2.2 PRE-COMMUNIST RULE.

2.2.1 The First Czechoslovak Republic: 1918-1938.

Whilst a unique type of reform is embodied in system creation, the First Republic remains the historical benchmark for a functioning capitalist economy in the Czech Republic, with respondents in the case study firms proudly referring to this heritage, and supposed inherent Czech ability to embrace such a system. The pre-Communist heritage made Czechoslovakia more favourably placed to sustain a democratic tradition than its Central and Eastern European neighbours in the inter-war years. There was a well-stratified class structure, educated population with some experience of group action and self-government, a tradition of egalitarianism and commitment to liberal values, and leaders sharing these values who were able to motivate the population.¹¹ Constitutionally, a democratic state with private ownership of industry

⁹ Jon Elster, Claus Offe, Ulrich K. Preuss with Frank Boenker, Ulrike Goetting and Friedbert W. Rueb, *Institutional Design in Post-Communist Societies: Rebuilding the Ship at Sea* (Cambridge: Cambridge University Press, 1998), p. 18.

¹⁰ Paul Aligica, 'The Institutionalists' Take on Transition', *Transition*, 3 (4) (1997), 46-49, p. 47.

¹¹ Wolchik, *Czechoslovakia in Transition*, pp. 3-5.

and banks was secured in 1920.¹² This ensured a degree of economic independence, but did not preclude a leading role for the government in guiding economic decisions.¹³ The new government as a social democratic coalition had a strong focus on developing and extending social security provisions.¹⁴ The bureaucracy was efficient and non-corrupt,¹⁵ with an inherited social security system that had been designed to support the industrial working class of the Austro-Hungarian Empire contributing to social stability in the Czech Lands especially.¹⁶ These factors were all beneficial to the country's economic development during this period. Now they are important because they can generate expectations amongst the population that the state has an obligation to intervene in the economic system, even where the economic situation belies this.¹⁷

Overall, the period from 1918 to 1937 saw economic consolidation during an era of political stability, attributable mainly to the administrative and political traditions inherited from the Habsburg Monarchy.¹⁸ The industrial sector diversified and matured, based on the skeletal but strong infrastructure already in place and supported by a liberal foreign trade regime, with 67.3% of Czechoslovakia's exports in 1937

¹² František Kavka, *An Outline of Czechoslovak History* (Prague: Orbis, 1960), p. 113; Jan Frait and Ramji Tamarappoo, 'Macroeconomic Stabilisation in the Czech Republic', in *Financial Market Restructuring in Selected Central European Countries*, edited by Karen S. Vorst and Willadee Wehmeyer (Aldershot: Ashgate, 1998), pp. 131-150, pp. 131-132.

¹³ William V. Wallace, *Czechoslovakia* (London: Benn, 1977), p. 156.

¹⁴ Jaroslav Krejčí, *Czechoslovakia at the Crossroads of European History* (London: Tauris, 1990), p. 141; Václav Průcha, 'Continuity and Discontinuity in the Economic Development of Czechoslovakia, 1918-91', in *Central Europe in the Twentieth Century: An Economic History Perspective*, edited by Alice Teichova (Aldershot: Ashgate, 1997), pp. 23-41, p. 25.

¹⁵ R. W. Seton-Watson, *25 Years of Czechoslovakia* (London: New Europe, 1945), p. 44.

¹⁶ Teichova, *Czechoslovak Economy*, pp. 78, 79.

¹⁷ Leff, *Czech and Slovak Republic*, p. 200.

¹⁸ J F. N. Bradley, *Czechoslovakia: A Short History* (Edinburgh: Edinburgh University Press, 1971), p. 153; Zora P. Pryor, 'Czechoslovak Economic Development in the Interwar Period', in *A History of the Czechoslovak Republic 1918-1948*, edited by Victor S. Mamatey and Radomír Luža (Princeton: Princeton University Press, 1973), pp. 188-215, p. 214; Robert Bideleux and Ian Jeffries, *A History of Eastern Europe: Crisis and Change* (London: Routledge, 1999), p. 292.

received by Western industrial nations.¹⁹ The period from 1919 until 1929 was characterised by economic strengthening, with the financial sector increasingly influential in encouraging investment and assisting the government in extending its economic policy.²⁰ Market forces were an important determinant of enterprises prospering or failing in the inter-war years. Although this set a useful precedent, the heavily concentrated traditional industries that dominated production in the Czechoslovak economy were hit hard by the Depression.²¹ By contrast, the economic authority of the USSR was enhanced by this event since its planned economy did not appear to be adversely affected, but even prospering at this time. A legitimisation of the USSR economic system in the eyes of Czechoslovak politicians began that persisted into the post-war era,²² but conditions in Czechoslovakia were far from suitable to the adoption of this model. The growth levels recorded in the USSR, notwithstanding the questionable statistical measures and the cost at which any growth was achieved, primarily reflected the effects of transforming from an agrarian to an industrialised economy.²³ The system was economically inefficient and unbalanced, and the detrimental effects of this could only be exacerbated if introduced into a more advanced economy such as Czechoslovakia that could not draw upon such a large reserve of underemployed agricultural labour as the USSR for labour-intensive production increases.²⁴

¹⁹ Hans Renner, *A History of Czechoslovakia Since 1945* (London: Routledge, 1989), p. 21.

²⁰ Kavka, *Outline*, p. 156.

²¹ Wallace, *Czechoslovakia*, p. 184.

²² Alan H. Smith, *The Planned Economies of Eastern Europe* (London: Croom Helm, 1983), p. 23.

²³ The processes involved in this are formalised in structural transformation models such as the Lewis model. Michael P. Todaro, *Economic Development*, 5th edition (Harlow: Longman, 1994), pp. 74-77.

²⁴ Smith, *Planned Economies*, p. 20; Jiří Kosta, 'The Czechoslovak Economic Reform of the 1960s', in *Czechoslovakia: Crossroads and Crises 1918-88*, edited by Norman Stone and Eduard Strouhal (Basingstoke: Macmillan, 1989), pp. 231-252, p. 233.

2.2.2 From the Second Republic to Post-War Democracy: 1938-1948.

The first rupture in the Czechoslovak state followed its territorial division under the Munich Agreement of 1938, and the creation of the Second Czechoslovak Republic. Slovakia was subsequently given independence and Bohemia and Moravia made a German protectorate from 1939 until 1945. When reconstituted as a united state, the Third Czechoslovak Republic had newly redrawn boundaries to reflect the geopolitical division of power in the aftermath of the Second World War.

The immediate post-war period until 1948 represented an experiment with new forms of economic and political organisation that in principle is mirrored in the aims of the transformation policies of the Czech governments since 1989. There was a continuation of the inter-war government's approach to economic and political systems in Czechoslovakia, but with a stricter emphasis on the role of centralised state control over the economy following the difficulties experienced in the First Republic during the Great Depression. This was intended to uphold the social democratic ideals promulgated by the leaders of Czechoslovakia and to curtail the negative impacts of capitalist free markets.²⁵ Beneš envisioned a "specific Czechoslovak way to socialism", justified by presumed differences stemming from Czechoslovakia's uniqueness in comparison with other countries of Central and Eastern Europe, and above all the Soviet Union.

In 1945, Czechoslovakia introduced central planning with market elements into a highly industrialised economy, and was able to take advantage of a relatively well-

²⁵ Teichova, *Czechoslovak Economy*, p. 91.

developed infrastructure, experienced and skilled labour force, and established trade relations and business practices.²⁶ Closely linked to, but distinct from nationalisation,²⁷ planning was advocated by the government for three reasons.²⁸ Firstly, the need for structural change and reconstruction after the war necessitated public investment to ensure the adequate provision of public goods. Secondly, the USSR's planned economy appeared to have coped with the Great Depression, whereas those countries relying on orthodox Keynesian methods of demand-side stabilisation suffered adverse distributional effects in national income. Finally, equality in income distribution was regarded as a benefit of planning and this was seen as best augmented by setting output targets rather than relying solely on the profit to motivate firms.

Economic development in the Third Czechoslovak Republic was to be achieved through the Košice Programme. Agreed to by all parties of the National Front,²⁹ it comprised three key elements; confiscation of property belonging to Nazi traitors and collaborators, state control to be imposed over finance and credit, insurance, natural and energy resources and other "key" industries, and planning of the economy.³⁰ The KSC did have a strong position within the National Front, but the non-Communists did not perceive state control and planning as synonymous. The long-term objective

²⁶ Teichova, *Czechoslovak Economy*, p. 92.

²⁷ H. Gordon Skilling, *Czechoslovakia's Interrupted Revolution* (Princeton: Princeton University Press, 1976), p. 850.

²⁸ Jan M. Michal, 'Postwar Economic Development', in *A History of the Czechoslovak Republic 1918-1948*, edited by Victor S. Mamatey and Radomír Luža (Princeton: Princeton University Press, 1973), pp. 428-460, p. 442.

²⁹ The structure of the National Front is significant in the development of the post-war political landscape. Beneš, in forming a new government held closely to the ideals of a homogenous society and so excluded many of the pre-war organisations as these following exclusively ethnic lines. Agreement was reached that only 6 parties would exist and that these should join under the umbrella of the National Front. Consequently, even before the KSC formalised single party rule, this existed in practice in Czechoslovakia. The creation of the National Front partly legitimised the emergence of a single party in 1948.

³⁰ Michal, 'Postwar Economic Development', p. 438.

of the Košice Programme was not a Soviet-type planned economy, but rather an experiment in “democratic socialism”.

The notion of state ownership of property in Czechoslovakia therefore has a longer history than the form it took under the Communists. According to the Košice Programme state control was to be achieved through four Nationalisation Decrees.³¹ Nationalisation was received favourably because it was felt to be in line with the Czechoslovak national consciousness.³² With both social and economic functions including the destruction of the petty bourgeoisie and land policies to achieve social justice,³³ there were also costs in terms of the perceived legitimacy of the regime and political freedom to be paid for this.³⁴ The result was a mixed economy combining public, nationalised and private enterprise forms that were intended to be of equal status in the post-war economic system. In reality though, even during the National Front years private ownership was being devalued against the preferred socialist organisation of enterprises.³⁵ Although “this strange mixture of principles and politics need not have doomed the Czechoslovak experiment in democratic socialism” its impact is hard to assess because “the three year period of trial was too short”³⁶ and the Communists seized power in February 1948, bringing the full adoption of the Soviet model of planning. Communist rule in Czechoslovakia then lasted until 1989, but the regime’s legitimacy passed through a number of periods of flux, with the 1968 Prague Spring its focal point.

³¹ Michal, ‘Postwar Economic Development’, p. 439.

³² Korbél, *Twentieth-Century Czechoslovakia*, p. 238; Wallace, *Czechoslovakia*, pp. 259-260.

³³ Wallace, *Czechoslovakia*, pp. 259-260.

³⁴ Korbél, *Twentieth-Century Czechoslovakia*, p. 238.

³⁵ Michal, ‘Postwar Economic Development’, pp. 444-445.

³⁶ Korbél, *Twentieth-Century Czechoslovakia*, p. 241.

2.3 COMMUNIST RULE: 1948-1989.

The introduction of the Soviet economic model, which defined the economic policy framework operating throughout this entire period initiated a rapid change in the nature, pace and direction of political and economic reform in Czechoslovakia. Between 1945 and 1948, Gottwald had continued to build upon the country's pre-war heritage whilst attempting in principle to adopt the economic system implemented in the USSR.³⁷ Some minor attempts at reform were made during this time reflecting the proposed "Czechoslovak way to socialism", but this was soon dropped after the Communists came to power in 1948 in favour of a comprehensive adoption of the measures practised in the USSR.³⁸ This was manifest principally by the new Czechoslovak leaders submitting their foreign and domestic policies to the Soviet model, and effectively renouncing the democratic and humanitarian principles that had characterised the interwar and immediate post-war periods.³⁹ The implementation and outworking of the Soviet model provides insights into the mentality infused into the management and workers in state-owned enterprises and the experiences they bring to transformation as an informal institution, as well as creating formal structures in enterprises and the supporting legislation that also persists into the transformation. Parallel hierarchies of political and economic influence were implied, but economics was subordinate to politics where these interests conflicted. This was the main factor contributing to the need for continual

³⁷ Martin Myant, *The Czechoslovak Economy 1948-1988: The Battle for Economic Reform* (Cambridge: Cambridge University Press, 1989), p. 7.

³⁸ Skilling, *Czechoslovakia's Interrupted Revolution*, pp. 23, 26; Korbel, *Twentieth-Century Czechoslovakia*, p. 255; Myant, *Czechoslovak Economy*, p. 11; Průcha, 'Continuity and Discontinuity', p. 30.

³⁹ Renner, *History of Czechoslovakia*, p. 4.

adaptations and evolutions at all levels in the hierarchy to make the system operate more effectively, but that also precludes effective change during this time.

The Soviet economic model was a developmental strategy designed to bring industrialisation to underdeveloped regions, and not the indiscriminate application of a homogenous series of policies. Its implementation was subject to the constraints of the previously existing systems and subsequent adaptations were made in response to the prevailing conditions. Given the relatively advanced level of economic development that had already been attained in the Czech Lands, if at all appropriate, it was more so for Slovakia.⁴⁰ The Communists in Czechoslovakia therefore had to legitimise the introduction of this new economic strategy into a successful market economy, and so re-interpreted Czechoslovakia's history to present the new methods as a positive advance for the country.⁴¹ One of the aims of the new economic policy was to restructure the economy away from mixed ownership into one constituted almost exclusively around state or co-operative forms of ownership.⁴² Although there was a historical precedent for state ownership in Czechoslovakia in the Košice programme prior to the KSČ assuming power, there were predetermined boundaries to state and private ownership.⁴³ Nationalisation under central planning required this to be realigned so that it attained priority over all other forms of economic organisation in the economic system.⁴⁴

⁴⁰ Paul G. Lewis, *Central Europe Since 1945*, Postwar World (Harlow: Longman, 1994), p. 105; Leff, *Czech and Slovak Republic*, p. 51.

⁴¹ Jan Adam, *Employment and Wage Policies in Poland, Czechoslovakia and Hungary Since 1950* (London: Macmillan, 1984), p. 13.

⁴² Václav Průcha, 'Economic Development and Relations 1918-1989', in *The End of Czechoslovakia* edited by Jiří Musil (Budapest: Central European University Press, 1995), pp. 40-76, p. 65.

⁴³ Smith, *Planned Economies*, pp. 25, 29.

⁴⁴ Ben Korda and Ivo Moravčík, 'Thirty Years of Socialist Economic Development in Czechoslovakia', *Canadian Slavonic Papers*, 22 (1980), 481-495, p. 481.

Limitations in the Stalinist model were recognised in Czechoslovakia at an early stage.⁴⁵ It was an inescapable fact that the economic situation was deteriorating as a consequence of adopting this model, and in 1963 Czechoslovakia registered a negative economic growth rate.⁴⁶ Stalin's death was followed by some political relaxation in the Soviet leadership, allowing debate in Czechoslovakia over how to improve the operation of the model given its failings in that country. This occurred in two main waves, the first from 1953 until the Prague Spring in 1968 and the second occurring in its aftermath and lasting until transformation began in 1989.⁴⁷ Described below, these reform attempts were path-dependent but also embedded, building incrementally on previous measures⁴⁸ yet with limits prescribed by the prevailing political, and to a lesser extent, economic climate.

2.3.1 First Wave Of Reforms: From The 1950s To The Prague Spring.

The culmination of efforts to legitimise Communist rule through shifting political conditions in this first wave was the Prague Spring. Declining economic performance as early as 1953 in Czechoslovakia and popular discontent forced a re-orientation of economic policy, but even where it was increasingly evident that this was inappropriate, successive Five Year Plans showed a consistent application of the Stalinist model until 1961.⁴⁹

⁴⁵ Lewis, *Central Europe*, pp. 103-104.

⁴⁶ Korda and Moravcik, 'Thirty Years', p. 483; Wolchik, *Czechoslovakia in Transition*, p. 27; Lewis, *Central Europe*, pp. 103-104, 114.

⁴⁷ Władysław W. Jermakowicz and Jane Thompson Follis, *Reform Cycles in Eastern Europe 1944-1987. A Comparative Analysis from a Sample of Czechoslovakia, Poland and the Soviet Union* (Berlin: Duncker and Humblot, 1988), p. 74.

⁴⁸ Wolchik, *Czechoslovakia in Transition*, pp. 108-109.

⁴⁹ Skilling, *Czechoslovakia's Interrupted Revolution*, p. 22; Korda and Moravcik, 'Thirty Years', pp. 482-483; Teichova, *Czechoslovak Economy*, p. 142; Kosta, 'Czechoslovak Economic Reform', p. 233.

At this time, reformers were not merely seeking further attempts to deconstruct the pre-Communist traditions of the country. By drawing upon the failures of the 1950s and early 1960s, they focused on seeking to create dynamic efficiency through the implementation of market reforms within a planned system, mirroring similar debates in other socialist economies.⁵⁰ According to the KSC 1962 Congress “the nation’s economic problems were not to be blamed on individuals or social groups as had been done in the past, but were due to defects in the system itself”.⁵¹ This resulted in a decision to alter the incentive structures in the economy, and marked the shift from extensive growth through increased use of factors of production to intensive growth that improved the efficiency with which a given quantity of resources was used.⁵² To achieve this, the Communist Party charged a group of economists from the Institute of Economics headed by Ota Šik to create a reform programme in the mid-1960s. Its aim was to introduce “socialism with a human face”, and provided the first important milestone in reform attempts in Czechoslovakia by recognising that the political and economic system in its entirety had to be reformed, rather than just undertaking partial economic changes to overcome specifically identified problems.⁵³

The failure of this reform to have any major impact on the operation of the Czechoslovak economy arose because there was no discussion over changes in the supporting political regime as this would have been a politically unacceptable

⁵⁰ Skilling, *Czechoslovakia’s Interrupted Revolution*, p. 148; Adam, *Economic Reforms*, p. 25; Lewis, *Central Europe*, pp. 114-115; Jozef M. van Brabant, *The Political Economy of Transition: Coming to Grips with History and Methodology* (London: Routledge, 1998), p. 6.

⁵¹ Lida Urbanek, ‘Some Difficulties in Implementing the Economic Reforms in Czechoslovakia’, *Soviet Studies*, 19 (1967), 557-566, pp. 557-558.

⁵² Ivo Moravcik, ‘The Czechoslovak Economic Reform’, *Canadian Slavonic Papers*, 10 (1968), 430-450, pp. 432, 438.

⁵³ Moravcik, ‘Czechoslovak Economic Reform’, p. 438; Ota Šik, *Plan and Market Under Socialism* (White Plains, N.Y.: International Arts and Sciences Press, 1967); Berend, *Central and Eastern Europe 1944-1993*, p. 137.

declaration of the failure of the planned economy.⁵⁴ Because comprehensive planned management had become too cumbersome and ineffective, Šik's reforms endeavoured to introduce some market criteria into the economy, with planning retained for long-term strategic reasons.⁵⁵ At the heart of the resulting proposals was decentralisation, with increased autonomy at lower levels of the system. Plans retained their primacy in planning, but indirect economic instruments were also to be used in achieving specific economic goals, thus decentralising decision-making in the economy and creating a truly socialist market economy.⁵⁶ These proposals were incorporated into the document "On the Improvement of Planned Management of the National Economy", which was finally adopted following some modifications by the KSČ in 1965.⁵⁷

As Novotný claimed there was no need for a new direction in reform but rather "a partial compromise with the forces of change",⁵⁸ the Czechoslovak leadership was unprepared to implement fully all the recommendations made by Šik.⁵⁹ That the central authorities retained ultimate discretionary power and so could ensure that in practice the planning system remained unchanged was seen as the main impediment to change by the reformers who had only been set the task of proposing reforms to the economic instruments of control.⁶⁰ Only with deteriorating economic conditions that

⁵⁴ Korda and Moravcik, 'Thirty Years', p. 495; Průcha, 'Continuity and Discontinuity', p. 31; Myant, *Czechoslovak Economy*, p. 126.

⁵⁵ Miroslav Sokol, 'Changes in Economic Management in Czechoslovakia', *Czechoslovak Economic Papers*, 8 (1967), 7-18, p. 12; Václav Klusoň, 'Innovations and Planned Management', *Czechoslovak Economic Papers*, 23 (1985), 39-54, p. 47; Myant, *Czechoslovak Economy*, p. 112.

⁵⁶ Sokol, 'Changes in Economic Management', pp. 8, 12; Moravcik, 'Czechoslovak Economic Reform', p. 438-439, 443.

⁵⁷ Kosta, 'Czechoslovak Economic Reform', p. 233.

⁵⁸ George R. Feiwel, *New Economic Patterns in Czechoslovakia: Impact of Growth, Planning and the Market* (New York: Praeger, 1968), p. 146.

⁵⁹ Myant, *Czechoslovak Economy*, p. 119.

⁶⁰ Kosta, 'Czechoslovak Economic Reform', p. 233; Myant, *Czechoslovak Economy*, p. 133; Lewis, *Central Europe*, p. 116.

the Party deemed a threat to its political primacy was a serious attempt to introduce comprehensive reform made in the 1960s.⁶¹

Despite Novotný's endeavours to maintain a political hold over debates on economic reform, by 1968 Czechoslovak economists were expressing more radical views over the desirability and necessity for economic reform than the political leaders.⁶² This arose from the seeming legitimacy given to economists such as Šik who were charged with discussing reform in view of recurring critiques of the economic preference for direct planning, and was backed by public opinion.⁶³ As dissatisfaction with the prevailing system developed, the reformers had a tendency towards "an exaggerated view of what the market could and could not do" and "ambiguity and lack of sophistication of some concepts".⁶⁴ Preferring some change to none at all, the reformers attempted to seize any opportunity available to them to push through rapid reforms before the window of opportunity closed.⁶⁵ The problem facing reformers in the 1990s of having greater awareness of dissatisfaction with the *status quo* that any real comprehension of how best to enact change was in evidence some 30 years earlier.

⁶¹ Ian Jeffries, *Socialist Economies and the Transition to the Market: A Guide* (London: Routledge, 1993), p. 246.

⁶² Skilling, *Czechoslovakia's Interrupted Revolution*, p. 414; Korbel, *Twentieth-Century Czechoslovakia*, p. 273.

⁶³ Skilling, *Czechoslovakia's Interrupted Revolution*, p. 225; Myant, *Czechoslovak Economy*, pp. 112, 125.

⁶⁴ Feiwel, *New Economic Patterns*, p. 151.

⁶⁵ Andrzej Korbonksi, 'Political Aspects of Economic Reforms in Eastern Europe', in *Economic Development in the Soviet Union and Eastern Europe 1: Reforms, Technology and Income Distribution*, edited by Zbigniew M. Fallenbuchl, Papers from First International Slavic Conference, Banff, Alberta, 4-7 September 1974 (New York: Praeger, 1975), pp. 8-41, p. 14.

The opportunity to challenge the *status quo* came with the replacement of Novotný by Dubček in January 1968.⁶⁶ This did not solve the economic crisis of which the overall decline in the Czechoslovak economy was a certain indication, nor eliminate the political barriers to reform,⁶⁷ but Dubček was more amenable to the notions of a planned market and greater decentralisation of decision-making and enterprise autonomy. Increased openness of discussion was allowed, alongside pledges for economic decentralisation and reform measures to stimulate economic growth, which led inevitably to less strict political control over the economy. Dubček wanted to bring increased flexibility into the Party and democratisation of centralised decision-making by incorporating the demands and interests of society into liberalised economic and political realms, so that reform could advance much faster with the political sphere altered.⁶⁸

An important innovation was that the central role of enterprises and especially of workers was to be accepted⁶⁹ and developed under the “Action Programme of the Communist Party of Czechoslovakia” that was launched in April 1968.⁷⁰ Economic organisation by planning, with rewards made on the basis of plan fulfilment was to encourage quantitative rather than qualitative growth.⁷¹

⁶⁶ Myant, *Czechoslovak Economy*, p. 157.

⁶⁷ Skilling, *Czechoslovakia's Interrupted Revolution*, p. 448.

⁶⁸ Adam, *Employment and Wage Policies*, p. 68; Jermakowicz and Follis, *Reform Cycles*, p. 88; Myant, *Czechoslovak Economy*, p. 161.

⁶⁹ These ideas drew strongly from Polish and Yugoslavian ideas. Feiwel, *New Economic Patterns*, p. 150; Václav Holešovsky, ‘Planning and Market in the Czechoslovak Reform’, in *Plan and Market: Economic Reform in Eastern Europe*, edited by Morris Bornstein (New Haven: Yale University Press, 1973), pp. 313-345, pp. 329, 332; Skilling, *Czechoslovakia's Interrupted Revolution*, p. 148.

⁷⁰ Kosta, ‘Czechoslovak Economic Reform’, pp. 234-235.

⁷¹ J. Wilczynski, *The Economics of Socialism: Principles Governing the Operation of the Centrally Planned Economies in the USSR and Eastern Europe under the New System* (London: Allen and Unwin, 1970), p. 109.

Nonetheless, despite the inauguration of changes in the Action Plan, in reality the extent of direct participation by the workers in routine decision-making and management was barely extended.⁷² The main influence that workers had over the management throughout the period of central planning was in the realm of employment tenure. Since full employment was the intention of the planners, employers were restricted in the disciplinary measures they could use over the labour force,⁷³ and some workers still expect the commensurate job tenure under the uncertain conditions of transformation. Their widespread adoption would have implied a failing of existing management techniques and challenged the political and economic justification of the centrally planned economy and its organisational structures.⁷⁴ The conservative element wanted to retain its power and influence at all levels of the political and economic hierarchies since this enabled them to preserve their position and status as well as protecting against their incompetence or inability to adapt from being exposed.⁷⁵

Although preliminary steps were taken up to early June, the reforms proposed under the Action Programme were not implemented as political resistance to reform had not been eliminated by the change in leadership and it remained clear that political and economic reform had to occur in tandem.⁷⁶ Some changes were implemented following the May Plenum, but from June onwards, political tension mounted both

⁷² Marie Lavigne, *The Socialist Economies of the Soviet Union and Europe* (London: Robertson, 1974), p. 45.

⁷³ Simon Clarke, Peter Fairbrother, Vadim Borisov and Petr Bizyukov, 'The Privatisation of Industrial Enterprises in Russia: Four Case-Studies', *Europe-Asia Studies*, 46 (1994), 179-214, p. 180.

⁷⁴ Lavigne, *Socialist Economies*, pp. 46-47.

⁷⁵ Wallace, *Czechoslovakia*, p. 303; Jan Winiecki, 'Obstacles to Economic Reform of Socialism: An Institutional-Choice Approach', *Annals of the American Academy of Political and Social Science*, 507 (1990), 65-71, p. 65.

⁷⁶ Skilling, *Czechoslovakia's Interrupted Revolution*, p. 448; Průcha, 'Continuity and Discontinuity', p. 32.

domestically and externally over the path that change was taking.⁷⁷ Although the Czechoslovak leadership pledged that socialism was not being rejected,⁷⁸ the USSR saw this as a mirror of the events in Hungary in 1956, which had resulted in Soviet military intervention. Czechoslovakia was warned that the other Warsaw Pact countries did not regard these reforms as only a domestic issue, but one that would have repercussions throughout the socialist bloc,⁷⁹ but Dubček continued the reform programme. With the USSR fearful of the destabilising effect that this might have on the region and at worst, the rejection of the socialist system in Czechoslovakia, Prague was invaded on August 21, decisively ending these reform efforts.⁸⁰

The events leading up to the Prague Spring and whether this was even a valid response by the other members of the Warsaw Pact is well documented.⁸¹ Of importance here is the impact that this event had on the nature of reform in Czechoslovakia during the remainder of the Communist era, and on the subsequent post-Communist reforms, because it altered both the formal institutional environment by precluding change of the socialist economic and political system, and also reinforced an expectation that no meaningful reform effort could be made under these conditions.

⁷⁷ Skilling, *Czechoslovakia's Interrupted Revolution*, pp. 275, 284, 288.

⁷⁸ Leff, *Czech and Slovak Republic*, pp. 58-59.

⁷⁹ Skilling, *Czechoslovakia's Interrupted Revolution*, p. 290; Renner, *History of Czechoslovakia*, p. 68.

⁸⁰ Korb, *Twentieth-Century Czechoslovakia*, pp. 302-303, 305; Teichova, *Czechoslovak Economy*, p. 159.

⁸¹ See for example Skilling, *Czechoslovakia's Interrupted Revolution*; Leff, *Czech and Slovak Republic*.

2.3.2 Reforms In The Second Wave: From Prague Spring To Velvet Revolution.

Czechoslovakia became a politically and economically ardent follower of the USSR through the suppression of reform and revoking many of the measures that had preceded the Prague Spring. Husák succeeded Dubček in 1969, and established a government comprising those who had either denounced or never publicly supported those reforms.⁸² "Normalisation" began, centred around three principal activities of personnel purges to reinstate politically centralised control, tight censorship, and the re-implementation of central control over the economy.⁸³ Although economic reforms were subsequently considered after 1968, since they could not circumvent the politically discredited ideas of centralised planning they were of limited impact.⁸⁴ The severity of the August 1968 invasion made it evident to the reformers that real change would not be tolerated by the USSR⁸⁵ because this necessitated a relaxation of the political hold over the economy, and "preservation of this feature seems to be the limit of the reforms: beyond it the economy loses its socialist character".⁸⁶ An uneasy compromise was thus attained in Czechoslovakia, with a nominally high degree of public conformity and political temperance achieved⁸⁷ at the cost of material concessions to the population and relatively lax discipline in the workplace.⁸⁸

⁸² Ben Fowkes, *The Rise and Fall of Communism in Eastern Europe*, 2nd edition (Basingstoke: Macmillan, 1995), pp. 138-139.

⁸³ Jermakowicz and Follis, *Reform Cycles*, pp. 91-92; Bernard Wheaton and Zdeněk Kavan, *The Velvet Revolution: Czechoslovakia, 1988-1991* (Boulder: Westview Press, 1992), pp. 6-9.

⁸⁴ Ben Korda and Ivo Moravcik, 'Reflections on the 1965-1968 Czechoslovak Economic Reform', *Canadian Slavonic Papers*, 13 (1971), 45-63, p. 62; Teichova, *Czechoslovak Economy*, p. 163.

⁸⁵ Leff, *Czech and Slovak Republic*, p. 64.

⁸⁶ Andrzej K. Koźmiński, 'Market and State in Centrally Planned Economies', *Current Sociology*, 38 (1990), 133-155, p. 139.

⁸⁷ Wheaton and Kavan, *The Velvet Revolution*, pp. 9-11.

⁸⁸ Anna Soulsby and Ed Clark, 'Privatisation and the Restructuring of Enterprise Social and Welfare Assets in the Czech Republic', *Industrial Relations Journal*, 26 (1995), 97-109, p. 100.

Because of fears that economic decentralisation would weaken the government's control over the population, changes implemented between 1965 and 1968 were revoked and economists reluctantly reverted to following Marxist-Leninist principles.⁸⁹ Centralised wage controls were re-introduced in 1970, and binding plan targets once again became the central mechanism for directing economic decision-making.⁹⁰ A new administrative reform began in 1971 in recognition of the lack of control that the state had over enterprise management. Industrial associations comprising enterprises operating within the same branch were established to bring their management under the same control jurisdiction. Two types of association were established, with a *trust* formed between horizontally integrated enterprises, and a *konzern* comprising enterprises linked vertically. These intermediaries between enterprises and the central administration created a less bureaucratic environment for firms to operate in. Enterprises could in principle leave an association provided they were then made responsible to the appropriate Ministry, but in practice this right was restricted.⁹¹

Questions of economic reform again appeared on the political agenda in the 1980s in response to economic decline in the 1970s. This had been caused by an emphasis on central planning and focus on heavy industry;⁹² declines in the quantity and quality of

⁸⁹ Oldřich Kýn, 'Czechoslovakia', in *The New Economic Systems of Eastern Europe*, edited by Hans-Herman Höhmann, Michael Kaser and Karl C. Thalheim (London: Hurst, 1975), pp. 105-154, p. 148; Korda and Moravcik, 'Thirty Years', p. 495.

⁹⁰ Kýn, 'Czechoslovakia', p. 121; Jermakowicz and Follis, *Reform Cycles*, p. 94; Myant, *Czechoslovak Economy*, p. 184; Jeffries, *Socialist Economies*, p. 247.

⁹¹ Lavigne, *Socialist Economies*, pp. 43-44, 82.

⁹² Jan Adam, 'Transformation to a Market Economy in the Former Czechoslovakia', *Europe-Asia Studies*, 45 (1993), 627-645, p. 628.

resources;⁹³ external circumstances such as the energy crises,⁹⁴ and a changing paradigm of production in the world economy to which the countries of Eastern Europe failed to adapt, bringing consequent trade and therefore budgetary difficulties.⁹⁵ Despite attempts to “catch up” with the West, technological capital stocks often lagged by at least one generation.⁹⁶ The reforms under discussion in Czechoslovakia for much of the 1980s focused around incentives and management of the economic system in an endeavour to strengthen the legitimacy of the Communist regime vis-à-vis competing economic and political systems and ideologies.⁹⁷

Flaws in the design and control of the economy had been recognised since 1948,⁹⁸ but the first explicit attempt to redress these problems after the aborted efforts of the 1960s came in this decade. The supremacy of the plan and the need to centrally determine the character of the economic working environment was not challenged,⁹⁹ but changes in the style of planning were introduced to make enterprises more accountable for their own production decisions and the consequences of these choices.¹⁰⁰ Hesitant steps were taken to reconsider the reform impetus of the 1960s, beginning with some moderate changes in the early part of the decade proposed and operated under the auspices of the Institute of Forecasting of the Czechoslovak

⁹³ Jaroslav Krejčí, ‘The First Republic’, in *Czechoslovakia 1918-1992: A Laboratory for Social Change*, edited by Jaroslav Krejčí and Pavel Machonin (Basingstoke: Macmillan, 1996), pp. 57-70, p. 70.

⁹⁴ Teichova, *Czechoslovak Economy*, p. 162; Ivan Szelenyi and Balazs Szelenyi, ‘Why Socialism Failed: Toward a Theory of System Breakdown – Causes of Disintegration of East European State Socialism’, *Theory and Society*, 23 (1994), 211-232, p. 223; Krejčí, *Czechoslovakia at the Crossroads*, pp. 89-90.

⁹⁵ Myant, *Czechoslovak Economy*, pp. 190-191.

⁹⁶ Victor Nee and Peng Lian, ‘Sleeping with the Enemy: A Dynamic Model of Declining Political Commitment in State Socialism’, *Theory and Society*, 23 (1994), 253-296, pp. 258-259; Szelenyi and Szelenyi, ‘Why Socialism Failed’, pp. 223-224.

⁹⁷ Thomas A. Baylis, *The West and Eastern Europe: Economic Statecraft and Political Change*, Twentieth Century Fund Book (Westport: Praeger, 1994), p. 20.

⁹⁸ Myant, *Czechoslovak Economy*, p. 260.

⁹⁹ Adam, *Economic Reforms*, p. 192; Wheaton and Kavan, *The Velvet Revolution*, p. 30.

Academy of Sciences. The conclusion drawn from the "Set of Measures for the Perfection of the System of Planned Management" was that radical changes were required.¹⁰¹

Five Year Plans remained the central mechanism for planning and directing the economy, but in conjunction with these, additional documents were produced that included detailed measures designed to improve the operation of the centrally planned system.¹⁰² The 1980s programmes explicitly encouraged new methods of promoting economic efficiency in production and management via the controlled introduction of some components of the market into the economy.¹⁰³ A gradual programme of decentralisation and economic reform was initiated with the approval of two documents: "Principles for Restructuring the Economic Mechanism in the ČSSR" and "Concretisation of the Principle for the Restructuring of Economic Mechanism in the ČSSR" in 1987. Recognising the need for fundamental change in the basis and operation of the Czechoslovak economy, they anticipated the re-introduction of some market aspects including increased enterprise autonomy, profit as an indicator of success, greater direct involvement of workers in decision-making, and price and trade reform.¹⁰⁴ The main criticism levelled at these programmes was that despite the intention that any change would be very gradual, they were very limited and during their short period in operation their proposals were frequently ignored, or so modified as to make their practical impact negligible.¹⁰⁵

¹⁰⁰ Jiří Dvořák, 'The Reform of the Economic Mechanism in Czechoslovakia', *Czechoslovak Economic Papers*, 26 (1989), 7-17, pp. 10-11.

¹⁰¹ Dvořák, 'Reform of the Economic Mechanism', p. 7.

¹⁰² Wolchik, *Czechoslovakia in Transition*, p. 243.

¹⁰³ Adam, *Economic Reforms*, p. 190; Dvořák, 'Reform of the Economic Mechanism', pp. 10, 11.

¹⁰⁴ Wolchik, *Czechoslovakia in Transition*, p. 245; Ladislav Holy, *The Little Czech and the Great Czech Nation: National Identity and the Post-Communist Social Transformation* (Cambridge: Cambridge University Press, 1996), p. 150.

¹⁰⁵ Myant, *Czechoslovak Economy*, p. 209; Wolchik, *Czechoslovakia in Transition*, pp. 246, 247.

Institutionally, the effects of normalisation were felt most deeply in the informal sphere, impacting on the shape of reforms in Czechoslovakia even when formal institutional structures shifted. Since policy in Czechoslovakia reflected its counterpart in the USSR in form and content,¹⁰⁶ the rise of Gorbachev to power in the USSR could have encouraged the KSČ to plan extensions to the scope of reform in the 1980s.¹⁰⁷ As a result of the Prague Spring experience though, the Czechoslovak leadership in the 1980s was unwilling to embrace the openness principles implied by *glasnost*, which was the defining political legitimisation of *perestroika*.¹⁰⁸ Whilst the objectives for reform proposed by Gorbachev and the KSČ show strong congruity, both being ostensibly oriented towards the shifting of their economies onto paths of more intensive growth,¹⁰⁹ they differed fundamentally according to the intentions of the leaders in each country. Whereas in the USSR Gorbachev's reforms were to induce real, systemic changes, in Czechoslovakia the *status quo* was preferred, since the economy could sustain a further period of limited economic reform, but not the political consequences of radical change.¹¹⁰ Many of the same conditions and obstacles did not exist in Czechoslovakia as in the USSR. Consequently, *přestavba* (Czechoslovakia's programme of restructuring in the 1980s) that occurred from 1987 was not the equivalent of the Soviet Union's *perestroika* (their 1980s restructuring programme) but instead reflected a Czechoslovak response to the altered external conditions.¹¹¹

¹⁰⁶ Adam, 'Transformation to a Market Economy', p. 629.

¹⁰⁷ Adam, *Economic Reforms*, p. 191.

¹⁰⁸ John F. N. Bradley, *Czechoslovakia's Velvet Revolution: A Political Analysis* (New York: Columbia University Press, 1992), p. 29-30; Adam, 'Transformation to a Market Economy', p. 629; Lewis, *Central Europe*, p. 116; Martin Myant, *Czechoslovak Economy*, p. 250.

¹⁰⁹ Adam, *Economic Reforms*, pp. 169-170.

¹¹⁰ Adam, *Economic Reforms*, p. 226; Myant, *Czechoslovak Economy*, p. 249.

¹¹¹ Bradley, *Czechoslovakia's Velvet Revolution*, p. 30.

Although the Czechoslovak government's programmes of the 1980s were due to operate until after the turn of the century, these were never fully implemented. The revolution of 1989 rendered these reforms obsolete because they had been devised for the Communist regime that was now being rejected, and were only valid within this restricted political and economic environment.¹¹² Only removal of the threat of Soviet intervention allowed a change in the approach to reform in 1989, with a return to the pre-Communist principle of the government holding and maintaining a guiding role within a market economic system.

2.4 AFTER THE VELVET REVOLUTION.

In 1989, the symbiosis between politics and economics meant that a small catalyst resulted in the implosion of the Communist system and altered the prevailing systemic conditions.¹¹³ However, the Velvet Revolution did not initiate a smooth transfer from central planning to an economic system that provides a suitable accompaniment to a democratic political system. Systemic change is not simply the dismantling of the former system and replacing this with another model, but requires destruction, re-creation, and restructuring of the institutional environment of the old and new systems.¹¹⁴ As with the Communist assumption of power in 1948, the new politicians had to find some way of legitimising their rule, and this was sought in their pre-

¹¹² Holy, *The Little Czech and the Great Czech Nation*, p. 60; Průcha, 'Continuity and Discontinuity', p. 33.

¹¹³ Elster et al, *Institutional Design*, p. 8.

¹¹⁴ Andrew Berg, 'Does Macroeconomic Reform Cause Structural Adjustment? Lessons from Poland', *Journal of Comparative Economics*, 18 (1994), 376-409, p. 376; Jozef M. van Brabant, 'Privatization, Industrial Policy and Governing the Transitions', *Mocst-Most*, 4 (1994), 63-85, p. 74; Herman W. Hoen, *The Transformation of Economic Systems in Central Europe* (Cheltenham: Elgar, 1998), p. 4; Horst Tomann, 'The Return of the Habsburgs: Reflections on the Role of Institutions in Transition Economies', in *Financial Turbulence and Capital Markets in Transition*, edited by Jens Hölscher (Basingstoke: Macmillan, 2000), pp. 3-12, p. 6.

Communist heritage.¹¹⁵ As in other countries of Central and Eastern Europe, the political leadership seized upon these events as a “unique chance, to return to Europe, and to reverse its unsuccessful and sluggish development in the last few decades”,¹¹⁶ regardless of how realistic such expectations of such a reform being able to overcome structural discrepancies in the economy really were.¹¹⁷ Despite all of its failings “[t]he communist system was characterised by its own peculiar, relatively stable equilibrium”.¹¹⁸ Soviet control and Soviet-inspired models of political and economic management did establish parameters within which these countries, albeit with national variations, operated,¹¹⁹ in particular by enabling the development of institutions that worked under that system, and these are not easily or rapidly replaced in the immediate transformation era.¹²⁰ Returning to Europe cannot be merely a retrospective process, since both Eastern and Western Europe have diverged in their historical development under this politically created division. There is therefore a danger of the transforming economies merely attempting to mimic Western Europe as it appears to them, with the result that Central and Eastern Europe continues to lag behind Western Europe because of an inability to internalise appropriate changes and technological developments. Additionally, it would be unclear as to when

¹¹⁵ Misha Glenny, *The Rebirth of History: Eastern Europe in the Age of Democracy*, 2nd edition (London: Penguin, 1993), p. 25; Holy, *The Little Czech and the Great Czech Nation*, pp. 138-139, 146; Fawn, *Czech Republic*, pp. 83-84.

¹¹⁶ Václav Klaus, *A Road to Market Economy: Selected Articles, Speeches and Lectures Held Abroad* (Praha: TOP Agency, 1991), p. 24.

¹¹⁷ Lewis, *Central Europe*, p. 2; Hilary Appel and John Gould, ‘Identity Politics and Economic Reform: Examining Industry-State Relations in the Czech and Slovak Republics’, *Europe-Asia Studies*, 52 (2000), 111-131, p. 120.

¹¹⁸ Klaus, *Renaissance*, p. 8.

¹¹⁹ Vincent Edwards and Gloria Lee, ‘Models of Management Formation: Implications for Central and Eastern Europe’, *Journal for East European Management Studies*, 4 (1999), 292-305, p. 294.

¹²⁰ Alice H. Amsden, Jacek Kochanowicz and Lance Taylor, *The Market Meets its Match: Restructuring the Economies of Eastern Europe* (Cambridge, MA: Harvard University Press, 1994), p. 23; Michal Illner, ‘Post-Communist Transformation Revisited’, *Czech Sociological Review*, 4 (1996), 157-169, p. 163.

convergence had been attained, since this “target is both multiple and moving”,¹²¹ and so these countries need to define their own standards for successful transformation that will not necessarily correlate overtly with the form of other European economies.

The strongly centralised economy in Czechoslovakia under socialism gave rise to macro-economic stability that distinguished Czechoslovakia from its contemporaries in Central and Eastern Europe from 1989. Giving Czechoslovakia the chance to “concentrate on studying the reforms in other countries [and devote] time to studying mainstream economics”, Klaus saw this as “a sort of privilege”¹²² because it facilitated his government’s ability to control and direct the transformation programme.¹²³ However, Czechoslovakia’s historical legacy was a liability in other ways. The environment into which transformation was to be effected in Czechoslovakia showed a number of distortions and imbalances that had arisen as a result of Communist policies and needed to be corrected in the transformation before a market economy could emerge.¹²⁴ These included informational problems and particularly incentive difficulties,¹²⁵ as well as structural deficiencies in the tangible infrastructure that had undermined central planning.

State-owned industry was dominant at the time of transition with 97% of Czechoslovakia’s output in 1986 from the state sector and so the private sector was

¹²¹ Bernard Chavance and Eric Magnin, ‘National Trajectories of Post-Socialist Transformation: Is There a Convergence Towards Western Capitalisms?’, *Prague Economic Papers*, 7 (1998), 227-237, p. 229.

¹²² Klaus, *A Road to Market Economy*, p. 22.

¹²³ Frydman *et al*, *Privatization Process in Central Europe*, p. 52; Fawn, *Czech Republic*, p. 85.

¹²⁴ Lewis, *Central Europe*, pp. 3, 18-19.

¹²⁵ Joseph E. Stiglitz, *Whither Socialism?* (Cambridge, MA: MIT Press, 1994), pp. 198-201.

negligible,¹²⁶ capital markets were under-developed, and investment and production decisions were centrally determined, coupled with highly monopolised industrial markets. Investment priorities were skewed primarily towards military needs with the lowest priority accorded to the production of consumer goods. Whilst the share of the economy's resources diverted to services was much lower than in market economies this distortion was enhanced by the lack of a private sector because of legal prohibitions on private ownership. The large size of enterprises impeded the introduction of competitive pressures, and although significant emphasis had been placed on technical and vocational education and training in the centrally planned economy, the skills labour acquired are not necessarily readily transferable to the new forms of economic management.¹²⁷ Subsidised transfers of fuel from the USSR left the economy based on heavy industry that was largely dependent on energy inefficient and obsolete technology. Many of these industries are technologically backward compared to their trading counterparts in other nations. In the realm of foreign trade, bilateral agreements within the CMEA mechanism dominated, complimenting a national level of specialisation in production in the region. This de-linking from the international trade order meant that these countries had not been able to take advantage of many of the technological and knowledge advances made available by producers in the West, and as time is required to assimilate these changes,¹²⁸ Czech enterprises were therefore disadvantaged in attempting to gain new global market positions.

¹²⁶ Martin Myant, *Transforming Socialist Economies: The Case of Poland and Czechoslovakia* (Aldershot: Elgar, 1993), p. 227; Anna Pollert and Irena Hradecka, 'Privatisation in Transition: The Czech Experience', in *Industrial Relations Journal*, 25 (1994), 52-63, p. 52.

¹²⁷ Baylis, *West and Eastern Europe*, pp. 70-71.

¹²⁸ Martin Myant, 'Transforming the Czech and Slovak Economies: Evidence at the District Level', *Regional Studies*, 29 (1995), 753-760, p. 753.

A dependency culture was fostered under state socialism, demonstrated by institutionalised distrust¹²⁹ and nominal compliance with authority.¹³⁰ This distorted the operation of the economy and complicates the transformation to a market. Under Communist rule, reforms only had a limited credibility and resulted in inertia of people to adapt. This is replicated under the new conditions in the responses to uncertainty, for rather than seeing enterprises and individuals embracing the opportunity to change their behaviour and innovatively seeking ways to adapt to the new economic conditions and opportunities afforded,¹³¹ there is a blaming of mistakes and negative consequences from new policies almost exclusively on the former political and economic system. Also, although Czechoslovakia entered the post-communist era with a very small foreign currency debt since during its rule the KSČ continued the programme of fiscal conservatism that had been initiated under the conditions of the Great Depression,¹³² this encouraged the incoming government to emphasise tight monetary and fiscal policies and anti-inflationary measures.¹³³ Such political continuities were linked to a wider intellectual climate supporting the notion of social justice that ascribes state intervention a role in achieving this,¹³⁴ and which was perceived as a political heritage from the time of the First Republic.

¹²⁹ Myant, *Czechoslovak Economy*, p. 251; Baylis, *West and Eastern Europe*, p. 21.

¹³⁰ Petr Mareš, Libor Musil, and Ladislav Rabušic, 'Values and the Welfare State in Czechoslovakia', in *The New Great Transformation? Change and Continuity in East-Central Europe*, edited by Christopher G. A. Bryant and Edmund Mokrzycki (London: Routledge, 1994), pp. 78-98, p. 94.

¹³¹ Judy Batt, *East Central Europe: From Reform to Transformation*, Chatham House Papers (London: RIIA/Pinter, 1991), p. 83.

¹³² Bijan B. Agheuli, Eduardo Borensztein and Tessa van der Willigen, *Stabilisation and Structural Reform*, p. 1; Jan Svenjar, 'Czech and Slovak Federal Republic: A Solid Foundation', in *Economic Transformation in Central Europe: A Progress Report*, edited by Richard Portes (London: CEPR, 1993), pp. 21-57, p. 23.

¹³³ Josef C. Brada, 'The Economic Transition of Czechoslovakia from Plan to Market', *Journal of Economic Perspectives* 5 (4) (1991), 171-177, p. 172; Václav Klaus, *Česká Cesta* (Praha: Profile, 1994), p. 77.

¹³⁴ Václav Klaus, and Tomáš Ježek, 'Social Criticism, False Liberalism and Recent Changes in Czechoslovakia', *East European Politics and Societies* 5 (1991), 26-40, p. 28-29; Brada, 'Economic Transition', p. 172.

2.4.1 Transformation and Restructuring.

Political conditions in socialist Czechoslovakia after the Prague Spring meant that efforts at economic reform in the 1980s had been premised on an understanding that only gradual economic reform could occur, with no separation of politics and economics within the economy.¹³⁵ This continued to underlay the immediate thinking on economic and system transformation in Czechoslovakia from 1989 until September 1990, when the government proposed a new radical reform strategy.¹³⁶ As Finance Minister, Klaus followed the claims of many Western advisors and rejected gradual or partial reforms on the basis that they had proved inadequate in earlier reform attempts, and from a desire to implement changes that would not imitate or perpetuate the policies and strategies of Communism.¹³⁷ History having shown the failure of reformed socialism, he also felt it necessary to initiate some measures as soon as possible to prevent rent-seeking behaviour under conditions of uncertainty.¹³⁸

Central planning in Czechoslovakia was perceived by the reformers to represent a distorted market rather than a distinctly different economic paradigm.¹³⁹ In designing a reform strategy at the start of the transformation, reformers shared a commitment to marketisation of the economy, regardless of the speed at which they advocated

¹³⁵ Susan Baker and Petr Jehlička, 'Dilemmas of Transition: The Environment, Democracy and Economic Reform in East Central Europe – An Introduction', in *Dilemmas of Transition: The Environment, Democracy and Economic Reform in East Central Europe*, edited by Susan Baker and Petr Jehlička (London: Cass, 1998), pp. 1-26, p. 4.

¹³⁶ Valtr Komárek, 'Czech and Slovak Federal Republic: A New Approach', in *Economic Transformation in Central Europe: A Progress Report*, edited by Richard Portes (London: CEPR, 1993), pp. 58-106, pp. 59, 62.

¹³⁷ Klaus, *A Road to Market Economy*, pp. 12, 18; Vaclav Klaus, 'Policy Dilemmas of Eastern European Reforms: Notes of an Insider', in *Banking and Finance in Eastern Europe*, edited by Andreas R. Prindl (Cambridge: Woodhead-Faulkner, 1992), pp. 115-119, pp. 115-116; Jeffrey Sachs, *Poland's Jump to the Market Economy* (Cambridge, MA: MIT Press, 1994), p. 43.

¹³⁸ Klaus, 'Main Obstacles', pp. 84-85, 87; Václav Klaus, *Rok Málo či Mnoho v Dějinách Země* (Praha: Repro-Media, 1993), p. 89.

transformation to occur.¹⁴⁰ Such differences in perception over the speed at which reform should occur were responsible for the split in Civic Forum in 1991. From this emerged the right-wing Civic Democratic Party under the leadership of Klaus, and in addition to some smaller groups, Civic Movement and the Civic Democratic Alliance that were more centrist, and also less focused in their objectives.¹⁴¹ The debate on whether reform should be implemented quickly or more gradually, with the design and speed of implementation of the privatisation programme the defining issue, was primarily between Klaus and Komárek, the then Deputy Prime Minister.¹⁴²

Supporters of radical reform under Klaus, propounding a combination of perceived myths as well as some realities of the prevailing economic conditions, won this debate in Czechoslovakia, with neither Civic Movement nor the Civic Democratic Alliance gaining parliamentary representation in the 1992 elections.¹⁴³

Klaus adopted a very clear neo-liberal rhetoric to describe the necessary changes that would underline this, with the ultimate goal as “an end of traditional economic paternalism”.¹⁴⁴ For this new government to appear ideologically distinct from its Communist forebears, it desired to redefine its role to be less directly involved in the economic operation of the economy.¹⁴⁵ Additionally, Czechoslovakia was in a

¹³⁹ Klaus and Ježek, ‘Social Criticism’, p. 33-34.

¹⁴⁰ Leff, *Czech and Slovak Republic*, p. 179; Klaus, *Česká Cesta*, p. 134; Bideleux and Jeffries, *History of Eastern Europe*, p. 548; Fawn, *Czech Republic*, p. 87.

¹⁴¹ Jon Elster, ‘Transition, Constitution-Making and Separation in Czechoslovakia’, *Archives Européennes de Sociologie*, 36 (1995), 105-134, pp. 118-119; Leff, *Czech and Slovak Republic*, p. 101; Fawn, *Czech Republic*, p. 87.

¹⁴² Svenjar, ‘Czech and Slovak Federal Republic’, p. 27.

¹⁴³ Frydman *et al*, *Privatization Process in Central Europe*, p. 71; Leff, *Czech and Slovak Republic*, p. 101.

¹⁴⁴ Klaus, *A Road to Market Economy*, p. 39.

¹⁴⁵ Gernot Grabher, ‘Eastern “Conquista”: The Truncated Industrialisation of East European Regions by Large West European Corporations’, in *Regional Development and Contemporary Industrial Response: Extending Flexible Specialisation*, edited by Huib Ernste and Verena Meier (London: Belhaven Press, 1992), pp. 219-232, p. 219.

favourable position to embrace the ideals of liberalism.¹⁴⁶ This arose from the relative stability of the economy and willingness of the electorate to endure a deterioration in economic conditions because of the existence of this "buffer", deep rejection of the socialist past, and a charismatic leadership able to gain the trust and support of voters. Secondary factors have been the break-up of Czechoslovakia, resulting in less dissent against the hardships endured by the population in the new Czech Republic, as well as favourable market conditions and concessions to social stability that bolstered support for Klaus' government. There was also the derived legitimisation in adopting these policies in that they were supported by the international organisations involved in the transformation processes such as the World Bank, IMF, and European Union.

Klaus was cautious about letting the reform process appear to be directed by outside influences. Certainly emulating these ideas facilitated a legitimisation of the new elites at a low political cost given the benefits it could bring.¹⁴⁷ Conversely, the demand-side stabilisation programmes that normally characterise the activities of the IMF were inappropriate in Central and Eastern Europe because of the pervasive legacies of state socialism and the resultant necessity for supply-side intervention to alter institutional conditions.¹⁴⁸ Receiving assistance and in particular financial aid could merely result in perpetuating the former dependent behavioural patterns by firms.¹⁴⁹ Klaus opted to minimise the financial assistance from these financial institutions, and claimed that

¹⁴⁶ Glenny, *Rebirth of History*, p. 22; Martin Dangerfield, 'Ideology and the Czech Transformation: Neo-liberal Rhetoric or Neo-liberal Reality?', *East European Politics and Societies*, 11 (1997), 436-469, pp. 437-438.

¹⁴⁷ Milada Anna Vachudová and Tim Snyder, 'Are Transitions Transitory? Two Types of Political Change in Eastern Europe Since 1989', *East European Politics and Societies*, 11 (1997), 1-35, p. 31.

¹⁴⁸ van Brabant, *Political Economy of Transition*, pp. 448-449.

[a]fter three years of relatively successful fundamental systemic transformation of the Czech economy and society my experience tells me that the role of external factors in this process is relatively small.¹⁵⁰

However, history shows all successful industrialisation periods globally have been founded on active state intervention.¹⁵¹ The new government's desire for a *laissez-faire* approach risked merely creating difficulties for enterprises in these new conditions by not providing a stable framework for growth. Unfortunately, restructuring outcomes in the case study firms confirm this, but it is only through the embedded institutionalism approach that the underlying factors that dictate this are fully identified.

Economic transformation in Czechoslovakia began formally on 1 January 1991 when the first measures from the Scenario of Economic Reform that Parliament had approved in late 1990 were introduced.¹⁵² In practice Klaus implemented a more judicious programme than his strongly neo-liberal reform rhetoric would suggest¹⁵³ because of the need to account for socio-political institutions as well as economic factors in the transformation. The need to deal with the conditions actually prevailing is very strong with regards to the debate over the nature of privatisation policies, because of its pivotal role in the transformation and the realisation of outcomes which differ from those projected by neo-classical economic theory.

¹⁴⁹ Klaus, *A Road to Market Economy*, p. 27.

¹⁵⁰ Janine R. Wedel, 'US Aid to Central and Eastern Europe: Results and Recommendations', *Problems of Post-Communism*, 42 (3) (1995), 45-50. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

¹⁵¹ John L. Campbell, 'Property Rights and Governance Transformations in Eastern Europe and the US', in *Institutional Change: Theory and Empirical Findings*, edited by Sven-Erik Sjöstrand (Armonk: Sharpe, 1993), pp. 151-170, p. 154; Amsden *et al*, *Market Meets its Match*, pp. 49, 171-176.

¹⁵² Svenjar, 'Czech and Slovak Federal Republic', pp. 27, 29.

¹⁵³ Leff, *Czech and Slovak Republics*, p. 180; Fawn, *Czech Republic*, p. 88.

Embeddedness is a very appropriate explanation in this context, reflecting the fact that inherited institutional structures may not be functional under altered economic conditions, and that successful transformation depends on the establishment and enforcement of new institutions.¹⁵⁴ Eliminating or overcoming resistance to reform, or ensuring that alternative organised forces support reform is essential to enable a progressive transformation to occur.¹⁵⁵ The potential impact of the elites and other interest groups in modifying or aborting the reforms to maximise their personal benefits,¹⁵⁶ alongside the credibility of the government's commitment to reform also have to be considered. In addition, this all needs to be augmented by an ethos of compliance by the population affected or a re-education of their values to make them favourably disposed towards these changes.¹⁵⁷ Delivering visible and positive results has already been shown historically to be imperative, otherwise the reform process could potentially be derailed as it may engender antipathy amongst the general population. The Communist accession to power was ultimately facilitated by extreme economic and political distortions, so the post-communist reformers need to ensure they understand the fragility of their status if the population are not fully prepared for negative reform consequences.¹⁵⁸ Resistance may come from reform fatigue or from opposition groups becoming better organised and able to effectively counter reform efforts,¹⁵⁹ but this can only be effectively identified and judged when the presence and impact of institutions is accounted for.

¹⁵⁴ Aligica, 'The Institutionalists' Take', p. 48; Hoen, *Transformation of Economic Systems*, p. 175.

¹⁵⁵ Adam Przeworski, *Democracy and the Market: Political and Economic Reforms in Eastern Europe and Latin America*, edited by Jon Elster and Michael S. McPherson (Cambridge: Cambridge University Press, 1991), p. 180.

¹⁵⁶ Winiecki, 'Obstacles to Economic Reform', p. 65; Batt, *East Central Europe*, p. 83.

¹⁵⁷ János Kornai, 'The Evolution of Financial Discipline Under the Post-Socialist System', *Kyklos*, 46 (1993), 315-336, pp. 320, 327; Aligica, 'The Institutionalists' Take', pp. 47, 49.

¹⁵⁸ Ota Šik, 'Revolutionary Changes in Czechoslovakia', in *Regional Development and Contemporary Industrial Response: Extending Flexible Specialisation*, edited by Huib Ernste and Verena Meier (London: Belhaven Press, 1992), pp. 247-259, pp. 257-258.

¹⁵⁹ Przeworski, *Democracy and the Market*, p. 165; Sachs, *Poland's Jump*, pp. 42-43.

2.5 CONCLUSION.

Reform events in the economic and political systems in Czechoslovakia prior to 1989 demonstrated path-dependent and embeddedness aspects because institutional influences led to the formal identification of a need for Czech responses to reform. Reformers in 1989 therefore inherited a unique legacy from the past that distinguished Czechoslovakia institutionally from other transforming countries in Central and Eastern Europe. In Klaus' neo-liberal reform rhetoric, these institutional aspects were not formally embraced, but the implementation of post-communist reforms undeniably exhibits path-dependent and embedded aspects.

As this chapter has shown, there exist numerous legacies from the country's history that act as institutional influences on the current transformation and the specific policies embraced in this. To create a market-based economy required the reintroduction of private property into these economies to overcome the previous dominance of state-owned industry. In Czechoslovakia, the government designed its initial policies in the 1990 Scenario of Economic Reform around an expectation that there would be a government-led restructuring of the economic infrastructure, enhanced by specifically targeted industrial policies of which privatisation would be one part. However

the government soon dropped the idea of an active restructuring policy and accepted the philosophy of the international financial institutions that structural changes were to be left to the market mechanism.¹⁶⁰

Privatisation became central to the entire transition,¹⁶¹ for the Klaus government having

initially cherished the illusion that it was easy to overcome the Communist heritage, has now changed its mind and is trying to move quickly ahead with its privatization and reprivatization programme.¹⁶²

Recognising the complex, and particularly the non-economic constraints, this policy instrument as the central element of the Klaus government's reform programme requires extensive consideration to determine whether it has achieved its goals. The following chapter begins this by presenting the privatisation policies of the Klaus government, and considering institutional determinants of its form and implementation.

¹⁶⁰ Jan Adam, *Social Costs of Transformation to a Market Economy in Post-Socialist Countries: The Cases of Poland, the Czech Republic and Hungary* (Basingstoke: Macmillan, 1999), p. 41.

¹⁶¹ Thomas W. Hazlett, 'The Czech Miracle: Why Privatization Went Right in the Czech Republic', *Reason*, 26 (11) (1995), 28-35. Academic Search Elite. EBSCO Publishing. 17 June 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; Václav Klaus, *Ekonomické Teorie a Realita Transformačních Procesů*, (Prague: Management Press 1995), p. 81; Tomáš Ježek, 'The Czechoslovak Experience with Privatization', *Journal of International Affairs*, 50 (1997), 477-488, p. 478.

¹⁶² Antoni Z. Kaminski and Piotr Strzalkowski, 'Strategies of Institutional Change in Central and Eastern European Economies', in *Institutional Change: Theory and Empirical Findings*, edited by Sven-Erik Sjöstrand (Armonk: Sharpe, 1993), pp. 139-150, pp. 147-148.

CHAPTER THREE

PRIVATISATION AND TRANSFORMATION

This chapter considers the Czech privatisation programme, its implications, and the extent to which it provides an appropriate foundation for sustainable development and long-term restructuring of enterprises during transformation. Limitations to applying existing models and experiences with privatisation to the Czech economy led to the Klaus government accepting the need for an eclectic approach to asset transfers.¹ In particular, in response to the prevailing economic and political conditions in the economy, a novel form of mass privatisation using vouchers was developed. Consequently, in the initial design of voucher privatisation, there is a response to institutions, even if this is not formally acknowledged, which further validates the use of the embedded institutionalism framework in understanding it.

The chapter begins by looking at the intended function of privatisation within the transformation. The component elements of the Czech privatisation programme are then presented, focusing particularly on voucher privatisation because of its centrality to privatisation and transformation, and as the method by which each firm in the case studies was privatised. A discussion of whether voucher privatisation can promote restructuring, and institutional limitations to this, follows.

¹ Václav Klaus, *Václav Klaus Narovinu. Hovory V.K s Petrem Hájkem Nejen o Tom, Co Bylo, Je a Bude* (Praha: Rabbit and Rabbit, 2001), p. 250.

Overall it is shown that institutional influences in the operating environment for Czech firms can create difficulties in achieving equitable and efficient property transfers and cause outcomes divergent from those predicted in theory, vindicating the use of non-standard privatisation methods. Voucher privatisation endeavours to overcome constraints from the institutional environment, in particular the novelty of private ownership and the lack of finance, through the use of vouchers. The Czech privatisation programme demonstrates a strong neo-classical inspiration in its intended outcomes, introduced by the government in the expectation that this would promote free market forces to bring efficiency gains. However, this chapter argues that institutional constraints define its overall structure, adoption, and therefore the consequent incentives for restructuring in privatised firms. This also pre-empts the discussion in subsequent chapters of the impact of specific institutional influences that determine the empirically observed restructuring in such enterprises.

3.1 THE ROLE OF PRIVATISATION IN THE CZECH REPUBLIC.

Privatisation gained a pivotal role in the Klaus government's reform strategy despite "no clear and incontrovertible evidence that privatisation leads to improvement in any case and under any circumstance".² This was because Klaus considered privatisation to be "a

² Bruno Dallago, 'Privatization: The Teaching of Western Experiences', in *Privatization and Economic Performance in Central and Eastern Europe: Lessons to be Learnt from Western Europe*, edited by Iván Major (Cheltenham: Elgar, 1999), pp. 1-42, p. 1.

crucial precondition for the normal functioning of a market economy",³ not only because of the economic benefits it brings, but because it could be used to justify the ideological underpinnings of the transformation by generating support for all aspects of reform.⁴

Privatisation in the Czech Republic differed by scale and objective from the process in developed market economies, being total privatisation to (re) introduce property and (re) create markets as an integral element of structural transformation in the economy.⁵ The overriding goal of privatisation in the context of transformation is to consolidate the gains from macroeconomic stabilisation and liberalisation, and to establish a market ethos that will ensure reforms implemented in the transformation maximise economic growth.⁶

With private ownership, budget constraints for firms are credibly hardened, transaction costs to obtaining government assistance increase, and firms are encouraged to respond to market signals with the result that efficient resource allocation and use occurs.⁷

³ Václav Klaus, 'Transition: An Insider's View', *Problems of Communism*, 41 (1-2) (1992), 73-75, p. 74.

⁴ Hilary Appel, 'Justice and the Reformulation of Property Rights in the Czech Republic', *East European Politics and Societies*, 9 (1995), 22-40, p. 39; Václav Klaus, *Ekonomické Teorie a Realita Transformačních Procesů*, (Prague: Management Press 1995), p. 12; Saul Estrin, 'Privatisation and Company Restructuring in Central and Eastern Europe: Issues and Progress', in *Entrepreneurship and Economic Transition in Central Europe*, edited by Jean-Paul Larçon (Dordrecht: Kluwer/HEC School of Management, 1998), pp. 21-35, pp. 21-22.

⁵ Václav Klaus, *Rebirth of a Country: Five Years After. Collection of Speeches of the Prime Minister of the Czech Republic* (Praha: Ringier, 1994), p. 38.

⁶ Scott Thomas, 'Political Economy of Privatisation in Poland, Hungary and Czechoslovakia', in *The Emergence of Market Economies in Eastern Europe* edited by Christopher Clague and Gordon C. Rausser (Cambridge, MA: Blackwell, 1992), pp. 279-295, pp. 279-280; David Parker, 'Unravelling the Planned Economy: Privatisation in Czecho-Slovakia', *Communist Economies and Economic Transformation*, 5 (1993), 391-404, p. 401; Tomáš Ježek, 'The Czechoslovak Experience with Privatization', *Journal of International Affairs*, 50 (1997), 477-488, pp. 478, 479.

⁷ Eduardo Borensztein and Manmohan S. Kumar, 'Proposals for Privatization in Eastern Europe', *IMF Staff Papers*, 38 (1991), 300-326, pp. 302-303; Jozef M. van Brabant, 'Property Rights Reform, Macroeconomic Performance and Welfare', in *Transformation of Planned Economies: Property Rights Reform and Macroeconomic Stability*, edited by Hans Blommestein and Michael Marrese (Paris: OECD/CEET, 1991), pp. 29-49, p. 38; Irena Grosfeld, 'Privatization of State Enterprises in Eastern Europe: The Search for a Market Environment', *East European Politics and Society*, 5 (1991), pp. 142-161, p. 147.

Privatisation can also aid the development of private capital markets, particularly when diverse methods of asset transfers are employed, since this increases the range of capital market instruments and tradeables in existence.⁸ Capital markets are useful for economic development by promoting efficient resource use, since firms need to demonstrate their profitability and remain competitive if they are to acquire additional funds here for production and expansion. Capital market development can be catalysed if formerly state owned property is distributed to the population by share issues. Share creation and consequently wider ownership is the basis for “popular capitalism” where large sections of the public become small shareholders from the distribution of shares from the privatisation of state property.⁹ Creating numerous new shareholders can be beneficial through encouraging a change in values and behaviour amongst these individuals, entrenching new interests, and also helping counter opposition to reform if privatisation is expected to bring improvements to enterprise efficiency. It also has a political benefit because the government gains legitimacy and support from the electorate by disseminating power in the economic sphere.

Distinct ownership structures differentially impact on efficiency because the structure of incentives and constraints under alternative property right allocations alters.¹⁰ From a

⁸ David J. Donaldson, *Privatization: Principles and Practice* (Washington: World Bank/IFC, 1995), pp. 32, 55.

⁹ Radek Laštovička, Anton Marcinčin and Michal Mejstřík, *Privatization and Opening the Capital Markets in the Czech and Slovak Republics*, Working Paper, 54 (Prague: CERGE, 1994), p. 3; Peter Saunders and Colin Harris, *Privatization and Popular Capitalism* (Buckingham: Open University Press, 1994), pp. 25-26; Ježek, ‘Czechoslovak Experience’, p. 485.

¹⁰ John Vickers and George Yarrow, *Privatization: An Economic Analysis* (Cambridge, MA: MIT Press 1988), p. 7; John McHale, ‘Postcommunist Eastern Europe: Privatization and the Second Fundamental Theorem’, in *Eastern Europe and the World Economy: Challenges of Transition and Globalization*, edited

Pareto-efficiency perspective, private ownership is advocated as the optimal institutional arrangement to balance private and social benefits (or costs) by generating incentives within the firm to achieve production and labour discipline. It also enhances the competitiveness of enterprises because contractual arrangements permit the direct monitoring of management.¹¹ Before efficient and equitable property transfers could be made in the Czech Republic, the institution of private property had to be recreated.¹² This did not exist under central planning, where the state was meant to exercise ownership on behalf of the population, but this had been more of an ideological stance than an economic reality. Private property rights that could be consistently and effectively enforced did not exist.¹³ Conflicts between the social and private use of resources generated a problem of the commons¹⁴ where an individual's benefit from the additional use of an asset increased by more than the marginal cost resulting from a reduction in aggregate social utility. This lack of private incentives to efficiency encouraged exploitation of the common (in theory socially-owned) property to the overall detriment of society.¹⁵

by Iliana Zloch-Christy (Cheltenham: Elgar, 1998), pp. 69-96, p. 89.

¹¹ Armen A. Alchain and Harold Demsetz, 'Production, Information Costs and Economic Organization', *American Economic Review*, 62 (1972), 777-795, p. 794; Borensztein and Kumar, 'Proposals for Privatization', p. 302.

¹² Václav Klaus, 'Main Obstacles to Rapid Economic Transformation of Eastern Europe: The Czechoslovak View', in *Towards a Market Economy in Central and Eastern Europe*, edited by Herbert Giersch (Berlin: Springer-Verlag/Egon-Sohmen Foundation, 1991), pp. 77-91, p. 87; Parker, 'Unravelling the Planned Economy', p. 402.

¹³ Kazimierz Z. Poznanski, 'Property Rights Perspective on Evolution of Communist-Type Economies', in *Constructing Capitalism: The Reemergence of Civil Society and Liberal Economy in the Post-Communist World*, edited by Kazimierz Z. Poznanski (Boulder: Westview Press, 1992), pp. 71-96, pp 79-80.

¹⁴ Garrett Hardin, 'The Tragedy of the Commons', *Science*, 162 (1968), 1243-1248, p. 1244. The implications of this are also discussed in the most well-know conception in R. H Coase, 'The Problem of Social Cost', *Journal of Law and Economics*, 3 (1960), 1-44.

¹⁵ János Kornai, 'Socialist Transformation and Privatization - Shifting From a Socialist System', *East European Politics and Societies*, 4 (1990), 255-304, pp. 273, 278-279.

Once property rights have been allocated, holders (principals) should be protected in their chosen selection of contractual claims on an asset or service, or they may choose other individuals (agents) to manage these resources on their behalf, establishing a contrast between the two parties.¹⁶ Adequately functioning legal protection and regulation through corporate governance should ensure that the provisions of these contracts are met in the ownership and management of the enterprise.¹⁷ Without monitoring, inefficiencies in the contractual arrangement will allow asymmetries between the utility functions of the principal and agent to create agency problems. Agency problems are liable to be particularly significant in the new economic environment of Central and Eastern Europe, even following privatisation, because of the enduring nature of institutions that mean appropriate monitoring does not exist or cannot operate effectively. As a result, post-privatisation restructuring within enterprises can be restricted, even though ownership transfers have occurred.

When transformation began in 1989 a three-tier legal system to govern commercial activity existed in Czechoslovakia, comprising a Civil Code regulating transactions between private individuals and enterprises, the Economic Code concerned with business relations between enterprises, and an International Code covering international trade issues.¹⁸ New forms of ownership were created with privatisation, making this existing

¹⁶ Stephen A. Ross, 'The Economic Theory of Agency: The Principal's Problem', *American Economic Review*, 63 (2) (1973), 134-139, p. 134; Ray Rees, 'The Theory of Principal and Agent: Part 1', *Bulletin of Economic Research*, 37 (1985), 3-26, p. 3.

¹⁷ Stephan Herten and Jens Hölscher, "'Anglo-Saxon' or 'Rhenish' Financial Markets for Central-East Europe?", in *Financial Turbulence and Capital Markets in Transition*, edited by Jens Hölscher (Basingstoke: Macmillan, 2000), pp. 13-24, p. 157.

¹⁸ Roman Frydman, Andrzej Rapaczynski, John S. Earle *et al*, *The Privatization Process in Central Europe*

legal framework inadequate after the collapse of central planning because it permitted only a limited spectrum of organisational forms; state-owned enterprises, co-operatives, municipal enterprises, and foreign trade enterprises.¹⁹ This necessitated property rights being defined and transferred through privatisation before efficient ownership patterns could emerge for Czech firms.²⁰ This chapter is concerned with the design and implementation of the privatisation programme in the Czech Republic and the institutional implications of voucher privatisation for enterprise restructuring. In the following chapter the implications for restructuring of the creation and transfer of property rights from the state to private owners are discussed through a consideration of emerging corporate governance in the Czech Republic.

3.2 METHODS OF PRIVATISATION IN THE CZECH REPUBLIC.

As Klaus and his government accepted the need for a rapid reform strategy, embracing a need to “move on all fronts at once – or not move at all”, an eclectic mix of policies was required to maximise the benefit of market forces in the transformation.²¹ Consequently, the privatisation programme had to effect the transfer of property into the private sector using a mix of policies of “asset privatisation” (rationalising production and sales of

(Budapest: Central European University Press, 1993), p. 51.

¹⁹ George E. Glos, ‘The New Czechoslovak Commercial Code’, *Review of Central and East European Law*, 18 (1992), 555-569, p. 555; Roman Frydman *et al*, *Privatization Process in Central Europe*, p. 51.

²⁰ Parker, ‘Unravelling the Planned Economy’, p. 402; Gerald A. McDermott, ‘Renegotiating the Ties that Bind: The Limits of Privatization in the Czech Republic’, in *Restructuring Networks in Post-Socialism: Legacies, Linkages and Localities*, edited by Gernot Grabher and David Stark (Oxford: Oxford University Press, 1997), pp. 70-106, p. 73.

²¹ Olivier Blanchard, Rudiger Dornbusch, Paul Krugman, Richard Layard and Lawrence Summers, *Reform*

fungible assets) and “transformational privatisation” (transferring former state-owned enterprises as going concerns into private ownership).²² Practically, this involved transferring enterprises from state to private ownership, greater provision of services by the private sector, the endogenous growth of the private sector as part of a market creating process, and reducing the proportion of production by the state sector relative to that of the private sector.²³

Klaus desired rapid privatisation as a precursor to the emergence of a market economy because it can create conditions favouring continuing private ownership.²⁴ However, the time that this could be expected to take by solely following existing models of privatisation was seen as too slow.²⁵ Traditional methods of privatisation were also perceived to result in the emergence of forms of ownership and corporate governance, which would be unacceptable from equity and efficiency perspectives if the incumbent management simply acquired control over their firms.²⁶ The concept of extending

in *Eastern Europe* (Cambridge, MA.: MIT Press, 1991), p. xi.

²² Leszek Balcerowicz, *Socialism, Capitalism and Transformation* (Budapest: Central European University Press, 1995), pp. 192-193.

²³ Balcerowicz, *Socialism, Capitalism and Transformation*, p. 186; Katharine Pistor and Joel Turkewitz, ‘Coping With Hydra-State Ownership after Privatization: A Comparative Study of the Czech Republic, Hungary and Russia’, in *Corporate Governance in Central Europe and Russia, 2: Insiders and the State*, edited by Roman Frydman, Cheryl W. Gray and Andrzej Rapaczynski (Budapest: Central European University Press, 1996), pp. 192-244, p. 193.

²⁴ Patrick Bolton and Gérard Roland, ‘Privatization Processes in Central and Eastern Europe’, *Economic Policy* 15 (1992), 275-309, p. 287.

²⁵ Václav Klaus, *A Road to Market Economy: Selected Articles, Speeches and Lectures Held Abroad* (Praha: TOP Agency, 1991), p. 22; Jan Mladek, ‘The Different Paths of Privatization in Czechoslovakia, 1990-?’, in *Privatization in the Transition to a Market Economy. Studies in Preconditions and Policies in Eastern Europe*, edited by John S. Earle, Roman Frydman and Andrzej Rapaczynski (London: Pinter, in association with Central European University, 1993), pp. 121-146, p. 130; Wladimir Andreff, ‘Corporate Governance of Privatized Enterprises in Transforming Economies: A Theoretical Approach’, *Most-Most*, 6 (1996), 59-80, p. 59.

²⁶ Mladek, ‘Different Paths’, p. 130.

privileges to insiders was ideologically opposed by the government and the population as a whole, for this discriminates against employees in sectors not to be privatised, and perpetuates injustices from the previous system configured to benefit those who may not have merited it.²⁷ Instead, Klaus hoped that Czech privatisation would encourage the emergence of new owners to undertake the necessary restructuring of firms, precluding government-directed restructuring of firms prior to asset sales.²⁸

Many analogies can be drawn between the inspiration for the Czech programme and the privatisation experiences of developed market economies in the 1980s, despite Klaus claiming to recognise that

[s]tandard measures, such as those used in the past in the UK, are insufficient for a transfer of so much property which is conditional on fundamental changes in the function of the economy within the existing time constraints.²⁹

Benefits could be expected to accrue from mirroring such conditions because

²⁷ Václav Klaus, *O Tvář Zítřka (Rok Devadesátý)* (Praha: Pražá Imaginace, 1991), pp. 60-61; Martin Kupka, 'Transformation of Ownership in Czechoslovakia', *Soviet Studies*, 44 (1992), 297-311, pp. 306, 309; Appel, 'Justice', p. 30.

²⁸ Václav Klaus, *Ekonomická Věda a Ekonomická Reforma. Statě, Eseje* (Praha: Gennex/TOP Agency, 1991), p. 270; Thomas W. Hazlett, 'The Czech Miracle: Why Privatization Went Right in the Czech Republic', *Reason*, 26 (11) (1995), 28-35. Academic Search Elite. EBSCO Publishing. 17 June 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

²⁹ Václav Klaus, 'Economic Reform in Czechoslovakia and the Role of Foreign Assistance', in *Financial Strategies and Public Policies. Banking, Insurance and Industry*, edited by Zuhayr Mikdashi (Basingstoke: St Martins Press, 1993), pp. 90-94, p. 92.

[p]rivatisation has an important demonstration effect. The more successful privatisation is perceived to have been in achieving its objectives, the more likely governments will be either to continue or step up their privatisation efforts.³⁰

Nonetheless, privatisation in the Czech Republic was introduced into an institutionally distorted economy, so it is questionable whether the efforts of the Klaus government to mimic privatisation experiences from other countries were appropriate.³¹ It appears from the design of the Czech programme that the extent of such institutional differences was underestimated at the outset of the transformation. Klaus believed that market forces would operate to bring efficiency gains from privatisation and restructuring, as predicted by neo-classical economics, and did not expect that the outcomes of privatisation would differ in the Czech Republic from those of other countries with similar programmes. In practice, insufficient adaptations were made to counter the institutional pressures, which had the effect of discouraging restructuring in former state-owned enterprises undergoing privatisation, to the detriment of the overall operation of privatisation and the transformation as a whole.

Klaus subsequently commented on such problems upon recognising that whilst many

³⁰ Barrie Stevens, 'Prospects for Privatisation in OECD Countries', *National Westminster Quarterly Review*, August 1992, 2-22, p. 11.

³¹ András Inotai, 'Experience with Privatization in East Central Europe', in *Privatization: Symposium in Honor of Herbert Giersch*, edited by Horst Siebert, Institut für Weltwirtschaft an der Universität Kiel (Tübingen: Mohr, 1992), pp. 163-182, p. 163.

Western countries and some developing countries have also embarked on privatisation ... [u]nfortunately and surprisingly, it has almost nothing in common with the task we face. The experience accumulated during such a process may be misleading when used in the context of transformation in Central and Eastern Europe. Privatization in our case does not mean the standard shift of property rights between two (or more) well-defined economic agents but the establishment of a property rights structure that was previously either non-existent or very strange. Privatizing in the West may be viewed as a "reform" process. In the East, however, privatization is the most fundamental objective of a systemic transformation. Looked at that way, privatization in the post-communist world is not a process by which property changes hands. Rather, it is the process by which the "non-owner" or quasi-owner, the government, transfers the "non-assets" to their initial owners and by doing so "creates" the "assets".³²

Such recognition does not preclude the design of voucher privatisation being premised on neo-classical economic orthodoxy, but institutional influences on the transformation meant that some adaptations to the institutional environment were needed in its conception and operation. This was seen most clearly in the need to overcome financial limitations to individual participation, so a composite programme was desired where

³² Václav Klaus, *Renaissance: The Rebirth of Liberty in the Heart of Europe* (Washington: Cato Institute, 1997), pp. 70-71.

[t]he first stage is the commercialization of the existing state firms, their transformation into the privatizable form, which means the creation of state joint stock companies in the crucial part of the Czechoslovak economy by means of auctions. This is a standard procedure. We have, however, one specific addition to it. Because of the lack of domestic capital, it will be necessary to augment the wealth of the population by distributing free a part of state property in the form of vouchers to the population at large. After that it would be possible to start the exchange of vouchers for the shares of the state joint stock companies.³³

The result was a mass privatisation programme favourably oriented to domestic participation, and creating a new class of entrepreneurs³⁴ that satisfied the socio-political demands of the transformation by engendering greater levels of support for the reforms, even if this involved some economic costs.³⁵

Five methods of privatisation were defined for Czech privatisation;³⁶ restitution, municipalisation, transformation of cooperatives, and small-scale and large-scale privatisation. These latter two distinctions were devised on the basis of assimilated Western advice that such a dichotomous approach is needed to account for the differing

³³ Klaus, *A Road to Market Economy*, pp. 21–22.

³⁴ Marie Lavigne, *The Economics of Transition: From Socialist Economy to Market Economy* (Basingstoke: Macmillan, 1995), pp. 166, 167–168.

³⁵ Lina Takla, 'The Relationship Between Privatization and the Reform of the Banking System: The Case of the Czech Republic and Slovakia', in *Privatization in Central and Eastern Europe*, edited by Saul Estrin (Harlow: Longman, 1994), pp. 154–175, p. 155; CIPE/USIA, *Privatizing State Owned Companies*, Prosperity Paper, 3. 11 March 1999. <<http://www.cipe.org/prosperity/pp3.html>>, [n.p.].

³⁶ Jan Mladek, 'Voucher Privatisation in the Czech Republic and Slovakia', in *Mass Privatisation: An Initial Assessment*, edited by Stilpon Nestor (Paris: OECD/CCET, 1995), pp. 61–85, p. 64.

nature of assets, requiring alternative approaches for their transfer into the private sector within the overall privatisation programme.³⁷ The inclusion of any given assets in one of these approaches was not made according to any predefined criteria but rather by reference to the speed and ease by which their divestiture was expected to occur.

Retail and service assets tended to comprise the core of those included in the small-scale programme, and incorporated assets available to be privatised with little or no pre-privatisation restructuring. Divisible assets from large plants not viable for privatisation in their entirety have been incorporated into this process.

Large-scale privatisation was the main approach to privatisation in the industrial manufacturing sector, and quantitatively the most important method for asset divestiture.³⁸ It was to facilitate the transfer of large, indivisible assets into private ownership with limited pre-privatisation restructuring. The central element of this was mass privatisation through the use of vouchers.

Before considering voucher privatisation in more detail, the procedures of restitution and small-scale privatisation are outlined, as these were techniques applied to some firms in the manufacturing sector, and even with firms where some assets were included in voucher privatisation, as privatisation methods were not mutually exclusive. Amongst

³⁷ Stanley Fischer, 'Privatization In East European Transformation', in *The Emergence of Market Economies in Eastern Europe* edited by Christopher Clague and Gordon C. Rausser (Cambridge, MA: Blackwell, 1992), pp. 227-243, p. 227.

³⁸ Evžen Kočenda, 'Stát Soukromíkem', *Ekonom*, 18-24 November 1999, 22-23, p. 22.

the case-study firms, this applied to the Drazitest state-owned enterprise. It is therefore important to discuss these elements of privatisation because they help to determine the institutional environment within which voucher privatisation occurred. By offering alternative forms of asset transfer and divestiture, varying patterns of incentives to change are created amongst new owners. These also ensured that some privatisation was experienced within the economy before large-scale privatisation began, and helped create the institution of private property. Both were important institutional catalysts to encouraging and supporting transformation and particularly restructuring within enterprises as privatisation occurs. Municipalisation and the transformation of co-operatives are not discussed further since these forms of ownership are rarely applicable to the assets being privatised in this sector and do not feature in the case study firms.

3.2.1 *Restitution.*

One form of property transfers concerns property appropriated prior to nationalisation under Communist rule, with the original owners entitled to have these assets returned, or receive compensation through restitution where this was not possible.

In Czechoslovakia this was intended to be more than a symbolic gesture,³⁹ but rather the government's response to the perceived need to satisfy equity considerations by compensating Czechoslovak citizens for the nationalisation of their property in the 1940s

³⁹ Kupka, 'Transformation of Ownership', p. 301.

and 1950s.⁴⁰ It was supplemented by compensation payments offered for other injustices, such as the confiscation of assets belonging to former political prisoners, and substituted for direct restitutions where it was now optimal to retain continuity in ownership from the time of nationalisation.⁴¹ Such moral arguments and the justification that the original owners should be given the opportunity to return to their former activities also had a political benefit. By reducing the amount of property remaining in state ownership, restitution increases support for transformation by expanding the property-owning class, and promotes opportunities for other private ventures.⁴²

Speed was to be emphasised in all aspects of the Czechoslovak programme, but the intensive administrative demands of the restitution procedure slowed the privatisation processes.⁴³ Determining whether or not restitution should be undertaken, followed by extensive discussions on how this should be achieved, meant that the first restitution law did not appear until 1990. This was Act 298/1990 "On Regulations of Property Relations of Religious Orders and Congregations and the Archdiocese of Olomouc", and was followed by three further laws: Act 403/1990 "Mitigation of Property Related Injustices

⁴⁰ Bernard Wheaton and Zdeněk Kavan, *The Velvet Revolution: Czechoslovakia, 1988-1991* (Boulder: Westview Press, 1992), p. 156. Details of some of the terms for offering compensation are given in Roman Frydman *et al*, *Privatization Process in Central Europe*, p. 77.

⁴¹ Mladek, 'Different Paths', pp. 123-124.

⁴² Martin Myant, *Transforming Socialist Economies: The Case of Poland and Czechoslovakia* (Aldershot: Elgar, 1993), p. 229; Morris Bornstein, 'Non-Standard Methods in the Privatisation Strategies of the Czech Republic, Hungary and Poland', *Economics of Transition*, 5 (1997), 323-338, p. 324; John S. Earle, Scott G. Gehlbach, Zuzana Saková and Jiří Večerník, *Mass Privatization, Distributive Politics, and Popular Support for Reform in the Czech Republic*, Institute of Sociology Working Paper, 4 (Prague: Academy of Sciences of the Czech Republic, 1997), p. 22.

⁴³ Vic Duke and Keith Grime, 'Privatization in East-Central Europe: Similarities and Contrasts in its Application', in *The New Great Transformation? Change and Continuity in East-Central Europe*, edited by Christopher G. A. Bryant and Edmund Mokrzycki (London: Routledge, 1994), pp. 144-170, p. 152; Earle *et al*, *Mass Privatization*, p. 22.

(Small-Scale Reprivatisation Law), Act 87/1991 “On Out-of-Court Rehabilitations (Large-Scale Reprivatisation Law) and Act 229/1991 “On Regulation of Ownership of Land and Other Agricultural Property”.⁴⁴

Property that was subject to verification of restitution claims was ineligible to be entered into any other privatisation procedures until the claim was settled. Overlap between the establishment of legal provisions for restitution and the start of small-scale privatisation, with problems exacerbated by a need for court settlements over competing claims meant that some privatisations under the small and large-scale programmes had to be delayed.⁴⁵

As an aspect of privatisation, restitution can be criticised for a number of other reasons.⁴⁶ Eligibility was restricted to resident Czechoslovak citizens whose property had been nationalised between February 25 1948 and January 1 1990. Using the date of the Communist accession to power avoided the issue of the Sudeten Germans who had lost property after the end of the Second World War as well as other property seizures that had occurred since 1938 after the Munich Agreement. The restriction on citizenship also excluded Czech émigrés from claiming restitution unless they would return and take up permanent residency again.⁴⁷ Also, despite the objective of restitution to encourage

⁴⁴ Act 298/1990 *Zákon o Úpravě Některých Majetkových Vztahů Řeholních Řádů a Kongregací a Arcibiskupství Olomouckého*; Act 403/1990 *Zákon o Zmírnění Následků Některých Majetkových Křivd*; Act 87/1991 *Zákon o Mimosoudních Rehabilitacích*; Act 229/1991 *Zákon o Úpravě Vlastnických Vztahů k Půdě a Jinému Zemědělskému Majetku*; Roman Frydman *et al*, *Privatization Process in Central Europe*, pp. 50-51, 72.

⁴⁵ Mladek, ‘Different Paths’, pp. 122, 124, 126.

⁴⁶ Kupka, ‘Transformation of Ownership’, p. 301; Bornstein, ‘Non-Standard Methods’, p. 324.

⁴⁷ Mladek, ‘Different Paths’, pp. 122, 126; John S. Earle, Roman Frydman, Andrzej Rapaczynski, Joel Turkewitz, *Small Privatization: The Transformation of Retail Trade and Consumer Services in the Czech*

entrepreneurial activity, the emergence of a new business class may be hindered if the new owners of restituted property no longer have the incentive or capital to use this resource, with the current users lacking the right to own this property.⁴⁸ Meeting equity criteria is not always efficient, as this policy shows. There are very few alternatives available to the owners of restituted property, who can either manage the assets themselves or retain the existing users and devolve responsibility back to them. These alternatives risk a reduction in efficiency, and in the second scenario counters the equity principle of restitution. In rewarding the current enterprise insiders, it also contravenes the justice principle in the Czech scheme that does not give privileges to employees of enterprises to be privatised but stresses equality in access of all citizens to the privatisation process.⁴⁹ Finally, it was not only those whose property was nationalised after the Communists came to power who were disadvantaged, since all suffered from the declining state of the economy, but restitutions bring asymmetry into the privatisation process, and may perpetuate new inequalities in wealth.

Restitution clearly demonstrates a political justification, but it may be detrimental to promoting restructuring because it can institutionalise ownership that precludes economically beneficial property transfers. Nevertheless, for property that was not

Republic, Hungary and Poland (Budapest: Central European University Press, 1994), pp. 59-61.

⁴⁸ Saul Estrin, 'Economic Transition and Privatization: The Issues', in *Privatization in Central and Eastern Europe*, edited by Saul Estrin (Harlow: Longman, 1994), pp. 3-30, p. 26; Appel, 'Justice', p. 29.

⁴⁹ Estrin, 'Economic Transition', p. 26; Dinko Dubravčić, 'Entrepreneurial Aspects of Privatisation in Transition Economies', 47 (1995), 305-316, p. 311-312; Jon Elster, Claus Offe, Ulrich K. Preuss with Frank Boenker, Ulrike Goetting and Friedbert W. Rueb, *Institutional Design in Post-Communist Societies. Rebuilding the Ship at Sea* (Cambridge: Cambridge University Press, 1998), p. 178.

restituted there were other ways of transferring this from the state into private ownership, with techniques of small and large-scale privatisation set out below.

3.2.2 *Small-Scale Privatisation.*

Like restitution, small-scale privatisation was carried out under the auspices of local committees.⁵⁰ Any property not subject to restitution, inclusion in large-scale privatisation, or held by the state for legally specified exemptions to privatisation could be offered for small-scale privatisation.⁵¹ A new legal framework for this programme was developed, centred on two laws; Act 427/1990 "The Transfer of State Property and Some Goods to Other Legal or Natural Persons", and Act 500/1990 "Competencies of Czech Republic Governmental Bodies in the Matter of Transfer of State Property of Some Things to Other Legal or Physical Persons".⁵² These governed the parameters and implementation of small-scale privatisation respectively.⁵³

Sales and leasing of former state owned property and assets occurred under the small-scale privatisation programme by public cash auction, with the funds generated from this transferred to the NPF.⁵⁴ Sales techniques familiar from ownership transfers in Western

⁵⁰ Bolton and Roland, 'Privatization Processes', p. 283; Marko Simoneti, 'A Comparative Review of Privatisation Strategies in Four Former Socialist Countries', *Europe-Asia Studies*, 45 (1993), 79-102, p. 91.

⁵¹ Kupka, 'Transformation of Ownership', pp. 307-308.

⁵² Act 427/1990 *Zákon o Převodech Vlastnictví Státu k Některým Věcem Na Jiné Právnícké Nebo Fyzické Osoby*; Act 500/1990 *Zákon České Národní Rady o Působnosti Orgánů České Republiky ve Věcech Převodů Vlastnictví Státu k Některým Věcem Na Jiné Právnícké Nebo Fyzické Osoby*.

⁵³ A full description of the legal basis for this can be found in Earle *et al*, *Small Privatization*, pp. 59-61.

⁵⁴ Bolton and Roland, 'Privatization Processes', p. 283; Frydman *et al*, *Privatization Process in Central*

Europe were used, including direct sales to domestic or foreign investors, tenders, and auctions.⁵⁵ These resulted in the rapid emergence of retail outlets and the provision of other services to fill niches that had been neglected or under-provided in the centrally planned economy.⁵⁶ The first round of auctions was only open to domestic investors as part of the government's commitment to creating a class of domestic entrepreneurs.⁵⁷

Small-scale privatisation was regarded as successfully meeting its aims of a rapid and efficient reallocation of ownership rights to a large number of retail and service assets.⁵⁸ It covered the assets most amenable to privatisation by direct sales, which were those that could be divided into sufficiently small units affordable even by domestic investors. Also included were some assets and companies spun-off from larger enterprises.⁵⁹ Most significant for long term restructuring is that the owners and managers of these firms are often synonymous or otherwise have closely-related interests, which brings benefits because it allows effective monitoring of managers by the new owners.⁶⁰ Amongst the case study companies, only in the Drazitest state-owned enterprise were any of the assets privatised in this way. When the company was divided into five separate business units, three parts were purchased outright. Subsequently one of these companies underwent

Europe, p. 79.

⁵⁵ Country-based studies of these methods in Eastern Europe can be found in Earle *et al*, *Small Privatisation*.

⁵⁶ Earle *et al*, *Small Privatisation*, p. 67.

⁵⁷ Jan Adam, 'Transformation to a Market Economy in the Former Czechoslovakia', *Europe-Asia Studies*, 45 (1993), 627-645, p. 630; Raphael Shen, *Economic Reform in Poland and Czechoslovakia. Lessons in Systemic Transformation* (Westport: Praeger, 1993), p. 187; Earle *et al*, *Small Privatization*, pp. 68, 69.

⁵⁸ Earle *et al*, *Small Privatization*, p. 74.

⁵⁹ Josef Kotrba, 'Privatisation Processes in the Czech Republic: Players and Winners', in *The Czech Republic and Economic Transition in Eastern Europe*, edited by Jan Svenjar (San Diego: Academic Press, 1995), pp. 159-198, p. 162.

asset stripping by its management, but the other two have been able to use their purchases of physical capital from the parent plant to establish new and profitable companies. Of the remaining two business sections, one was dissolved and the other, Drazitest, privatised by voucher.

Techniques adopted under the small-scale programme could not be applied indiscriminately to all asset divestitures. Privatisation also had to effect the transfer of huge amounts of property that was virtually impossible to value meaningfully from state ownership into the hands of a population of limited financial and technical means.⁶¹ Instead, a mass privatisation approach had to be designed that would transfer ownership and so create new owners that were anticipated would take responsibility for restructuring the assets.⁶² This was the main, or only, privatisation technique adopted for all of the firms presented in the case studies. Theoretical projections are contrasted with the interview responses below to show how large-scale privatisation was intended to operate, and the ways in which institutions affect the actual outcomes.

⁶⁰ Daniel Gros and Alfred Steinherr, *Winds of Change: Economic Transformation in Central and Eastern Europe* (London: Longman, 1995), p. 286.

⁶¹ Ježek, 'Czechoslovak Experience', p. 479; Roman Frydman, Kenneth Murphy and Andrzej Rapaczynski, *Capitalism With a Comrade's Face* (Budapest: Central European University Press, 1998), p. 183.

⁶² Kotrba, 'Privatisation Processes', p. 164.

3.2.3 Large-Scale Privatisation.

Large-scale privatisation was based on a legal framework approved by Parliament in April 1991.⁶³ Initially, state-owned enterprises were to be converted into joint stock companies through Act 111/1990 on corporatisation, with the Ministry of Privatisation transferring assets to be privatised to the National Property Fund (NPF).⁶⁴ The NPF was intended to have a passive role as an interim holding company for the assets.⁶⁵ Designed to give enterprises greater financial autonomy under continued state ownership, only around 100 enterprises were involved before this was abandoned in favour of an approach where the NPF was to hold shares in corporatised enterprises and take responsibility for corporate governance until privatisation is realised.⁶⁶

Managers in enterprises listed for privatisation had to prepare a privatisation plan (basic project) detailing the proposed method(s) of privatisation for the enterprise as a whole, or for each combination of assets, along with information about the current financial state of the enterprise, and a business plan projecting its future development.⁶⁷ Any other potential investors were also required to produce similar plans (competing projects) for

⁶³ Act 92/1991 *Zákon o Podmínkách Převodu Majetku Státu Na Jiné Osoby (On Conditions and Terms Governing the Transfer of State Property to Other Persons)*; Frydman *et al*, *Privatization Process in Central Europe*, p. 79.

⁶⁴ Act 111/1990 *Zákon o Státním Podniku*; Frydman *et al*, *Privatization Process in Central Europe*, p. 91; Simoneti, 'Comparative Review', p. 91.

⁶⁵ Laštovička *et al*, *Privatization and Opening*, p. 3.

⁶⁶ Frydman *et al*, *Privatization Process in Central Europe*, p. 91.

⁶⁷ Frydman *et al*, *Privatization Process in Central Europe*, pp. 80-81; Earle *et al*, *Small Privatization*, p. 79; Nemcová, 'Lessons', p. 44.

the parts of the enterprise or assets they wished to acquire.⁶⁸ All the plans were submitted to the Ministry of Privatisation and from these the proposed investors and privatisation method(s) were selected. This evaluation procedure was firstly performed by the branch ministry or local government, and their recommendations passed onto the Czech or Slovak Privatisation Ministry or Federal Finance Ministry, where a final decision on the preferred privatisation approach was made.⁶⁹

Standard privatisation techniques including auctions, direct sales, tenders, and asset sales or transfers could be proposed for assets included in large-scale privatisation. However, these could not be relied upon exclusively⁷⁰ because of the scale of the task and the constraints to be overcome in the transformation, especially the problem of valuation.⁷¹ Once property rights have been assigned legally, asset valuation and corporatisation can follow, but there are attendant difficulties with this due to the weak financial and capital markets in the transformation environment.⁷² The financial legacy of the communist era made the valuation of firms to be privatised virtually impossible at the outset because the accounting system employed under central planning was meaningless outside this

⁶⁸ Frydman *et al*, *Privatization Process in Central Europe*, p. 80; Earle *et al*, *Small Privatization*, p. 79.

⁶⁹ Frydman *et al*, *Privatization Process in Central Europe*, p. 82; Mladek, 'Voucher Privatisation', p. 70.

⁷⁰ Mladek, 'Different Paths', p. 130; Frydman *et al*, *Privatization Process in Central Europe*, p. 80.

⁷¹ Roman Frydman and Andrzej Rapaczynski, 'Industrial Reform in Eastern Europe: Evolution or Design?', *Brigham Young University Law Review*, 18 (1) (1992), 1-21. Academic Search Elite. EBSCO Publishing. 24 April 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

Václav Klaus, *Proč Nejsem Sociálním Demokratem* (Olomouc: Votobia, 1998), p. 1998.

⁷² Kupka, 'Transformation of Ownership', p. 297; Scott Thomas, 'The Politics and Economics of Privatization in Central and Eastern Europe', *Columbia Journal of World Business*, 28 (1) (1993), 166-178. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

system.⁷³ Even if an adjusted measure comparable to Western accounting standards could be calculated, it was unclear how useful this would be. The historical performance of an enterprise operating under conditions of central planning is likely to have only limited predictive power over the firm's potential future performance, with many technically bankrupt, and others with large outstanding liabilities.⁷⁴ A non-standard variant, voucher privatisation, was designed to account for these conditions and supplement traditional measures in large-scale privatisation, and is described more fully in section 3.3.

Constitutionally any approach to privatisation of assets included in large-scale privatisation was equally valid, in principle allowing for a heterogeneous approach to ownership transfers since any combination of asset divestiture techniques could be proposed in a privatisation plan.⁷⁵ In practice, proposals electing to follow privatisation by voucher dominated those accepted. This was not necessarily because potential investors understood the implications of voucher privatisation or felt it was the optimal privatisation technique, but since projects were selected by the privatisation agency, the government retained some control over the process.⁷⁶ The Privatisation Ministries were known to have preferences for certain methods as each brought different political and economic benefits.⁷⁷ The timescale for plan approval was quite short,⁷⁸ so plans to use

⁷³ Bös, *Privatization*, p. 1; Arye L. Hillman, 'Progress With Privatization', *Journal of Comparative Economics*, 16 (1992), 733-749, p. 741.

⁷⁴ Thomas, 'Politics and Economics', [n.p.].

⁷⁵ Frydman *et al*, *Privatization Process in Central Europe*, p. 82.

⁷⁶ Laštovička *et al*, *Privatization and Opening*, p. 5.

⁷⁷ Frydman *et al*, *Privatization Process in Central Europe*, p. 82.

⁷⁸ Iraj Hashi and Alison Sinclair, 'Managerial Behaviour and Supply of Shares in the Czech Voucher

voucher were often preferred as these helped the Ministries meet the targets for the number of enterprises to be privatised in this way.⁷⁹ The large number of proposals including voucher privatisation as shown in Table 3.1 could therefore have arisen because of the perceived likelihood of its eventual acceptance.⁸⁰

Privatisation Programme', *Moct-Most*, 6 (1996), 103-121, p. 108.

⁷⁹ Vladimír Dlouhý and Jan Mládek, 'Privatization and Corporate Control in the Czech Republic', *Economic Policy*, 19 (Supplement) (1994), 156-170, p. 161; CIPE/USIA, *Privatizing State Owned Companies*, [n.p.].

⁸⁰ Archana Hingorani, Kenneth Lehn and Anil K. Makhija, 'Investor Behaviour in Mass Privatisation: The Case of the Czech Voucher Scheme', *Journal of Financial Economics*, 44 (1997), 349-396, p. 354.

Table 3.1: Privatisation Methods for Joint-Stock Companies.

Privatisation Method	Republic of JSC registration. ^a	% of shares offered by number of companies.				
		0	1-25	26-50	51-75	> 75
Voucher						
First Wave	Czech	0	14	108	177	689
First Wave	Slovak	0	7	2	49	419
Second Wave	Czech	0	76	112	114	374
Direct Sale to Domestic Buyer						
First Wave	Czech	898	24	28	35	3
First Wave	Slovak	472	11	9	10	1
Second Wave	Czech	594	21	35	27	0
Direct Sale to Foreign Buyer						
First Wave	Czech	947	12	14	15	1
First Wave	Slovak	493	2	5	2	0
Second Wave	Czech	660	6	5	5	0
National Property Fund Temporary						
First Wave	Czech	658	217	83	17	3
First Wave	Slovak	492	21	37	11	2
Second Wave	Czech	479	100	55	25	17
National Property Fund Permanent						
First Wave	Czech	960	23	5	0	0
First Wave	Slovak	472	3	17	6	0
Second Wave	Czech	673	1	1	1	0
Free Transfer of Shares						
First Wave	Czech	806	179	2	1	0
First Wave	Slovak	503	0	0	0	0
Second Wave	Czech	482	159	4	3	29

^a Voucher privatisation was only continued in the second wave in the Czech Republic.

Source: Kotrba, 'Privatisation Processes', p. 181.

Plans designed by the management were also most likely to be accepted, suggesting that insiders could exploit experience and information gained from their position in designing or submitting privatisation proposals, regardless of the ethics or legality of this.⁸¹ This affected the privatisation of Odraz KM where there was

a competing plan from the Odraz KM directors wanting the firm to be independent of Rukopis Strojírny, but Rukopis Strojírny heard of this and as they had much stronger government connections, the current plan prevailed. The main reason that Rukopis Strojírny could persuade the government of the need for their plan was the lack of independence of Odraz KM and its 56% production for Rukopis Strojírny (Odraz KM 1, Managing Director).

Another reason cited by the case study firms for selecting voucher privatisation was strategic, perceiving that

this was the only possibility at the time. There were no foreign owners interested in buying the firm, indeed not even any Czechs, so voucher privatisation was chosen (Přesnost KM 1, Financial Planning Manager)

⁸¹ Marie Bohatá, 'Some Implications of Voucher Privatization for Corporate Governance', *Prague Economic Papers*, 7 (1998), 59-65, p. 61; Nemcová, 'Lessons', pp. 44-45; Hilary Appel and John Gould, 'Identity Politics and Economic Reform: Examining Industry-State Relations in the Czech and Slovak Republics', *Europe-Asia Studies*, 52 (2000), 111-131, p. 113.

and in Rukopis Strojírny where it was through throughout the firm that “at the time there were no other ways to help the company and keep it alive” (Rukopis Strojírny 5, Assembly worker).

These are significant institutional constraints on the potential benefits of voucher privatisation, with firms potentially selecting this method not because it is anticipated to be the optimal privatisation solution from the perspective of restructuring, but because it offers the greatest chance of immediate survival for the firm.

3.3 PRIVATISATION BY VOUCHER.

Voucher privatisation was intended to be the dominant approach by which large-scale privatisation would be achieved in Czechoslovakia and the Czech Republic.⁸² This represented Klaus’ confidence in private ownership to promote efficiency and restructuring, despite voucher privatisation’s potentially incompatible aims of achieving dispersed ownership with effective control over enterprise insiders.⁸³ Voucher privatisation was designed to effect the necessarily large volume of transfers given the dilemma of scarce resources for investment. Despite excessive forced saving under the centrally planned economy, potential problems of a monetary overhang were alleviated by

⁸² Laštovička *et al*, *Privatization and Opening*, p. 3; Jan Hanousek and Eugene A. Kroch, ‘The Two Waves of Voucher Privatisation in the Czech Republic: A Model of Learning in Sequential Bidding’, *Applied Economics*, 30 (1998), 133-143, p. 133.

⁸³ Roman Frydman and Andrzej Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away?* (Budapest: Central European University Press, 1994), p. 107; Jan Klacek and Vladislav Flek,

absorption through small-scale privatisation purchases and inflation following price liberalisation. Instead, liquidity shortages and the absence or immature development of financial institutions meant that there would have been insufficient potential buyers to enable privatisation to occur effectively.⁸⁴ Prices would have been forced down to very low levels if determined only by demand. Similarly, if all the assets were to be privatised simultaneously, a condition that would be required to meet equity concerns, the flooded market would suffer artificially depressed prices.⁸⁵ This would encourage speculative purchases and possibly intensify asset stripping if whole units were purchased cheaply to gain access to any more valuable part.⁸⁶ Also, at the time of sale there may be no buyers for enterprises valued at a positive price, given the quantity of property offered for sale, the uncertain viability of assets and the low availability of financial capital,⁸⁷ creating the potential for too rapid a liquidation of firms that could be profitable in the long-term.⁸⁸

Exacerbated by valuation difficulties and the absence of financial institutions,⁸⁹ cash bids were therefore very problematic. Alternative methods of asset divestiture were required to cope with the volume of property to be privatised, and overcome the constraints faced by privatising under conditions of uncertainty with political and economic legacies that

Company Restructuring: The Czech Experience, Working Paper, 48 (Leuven: LICOS Centre for Transition Economics, 1995), p. 1.

⁸⁴ Thomas, 'Politics and Economics', [n.p.].

⁸⁵ Yudit Kiss, 'Privatization Paradoxes in East Central Europe', *East European Politics and Society*, 8 (1994), 122-152, p. 146.

⁸⁶ Blanchard *et al*, *Reform in Eastern Europe*, pp. xiv, 37; Thomas, 'Politics and Economics', [n.p.]; Frydman *et al*, *Capitalism With a Comrade's Face*, p. 13.

⁸⁷ Hillman, 'Progress With Privatization', p. 734; Gros and Steinherr, *Winds of Change*, p. 186.

⁸⁸ Raj M. Desai, 'Reformed Banks and Corporate Governance in the Czech Republic, 1991-1996', *Post-Soviet Geography and Economics*, 37 (1996), 463-494, p. 464.

⁸⁹ Aureliusz M. Pedziwol, 'The Great Game of Privatization', *Transition*, 3 (1) (1997), 36-40, p. 36.

created institutional constraints.⁹⁰ Distributing vouchers that were subsequently convertible into shares of formerly state-owned property was to help augment the wealth of the population.⁹¹ Making these transferable also helped lay the foundations for functioning capital markets and related institutions to emerge,⁹² which could subsequently provide additional financial resources for restructuring. Other benefits anticipated for voucher privatisation were that it would promote domestic ownership whilst allowing companies to potentially gain access to global capital markets through financial assistance and expertise transfers at the board level.⁹³ It was also designed to bring support for other reforms by linking citizens' interests to economic performance through their individual asset holdings, and directly tying the interests of beneficiaries of reform to a continuation of the government's reform policies.⁹⁴

Before looking at whether this brings the desired restructuring and the institutional

⁹⁰ Stanislaw Gomulka, 'Economic and Political Constraints During Transition', *Europe-Asia Studies*, 46 (1994), pp. 89-106, p. 97. Obstacles to divestment of former state owned assets in Eastern Europe are summarised in Jozef M. van Brabant, 'On the Economics of Property Rights and Privatisation in Transitional Economies', in *Privatisation Policy and Performance: International Perspectives* edited by Paul Cook and Colin Kirkpatrick (Hemel Hempstead: Prentice Hall/Harvester Wheatsheaf, 1995), pp. 48-83, pp. 63-69.

⁹¹ Klaus, 'Main Obstacles', p. 87; Radek Laštovička, Anton Marcinčin, and Michal Mejstřík, 'Corporate Governance and Share Prices in Voucher Privatised Companies', in *The Czech Republic and Economic Transition in Eastern Europe*, edited by Jan Svenjar (San Diego: Academic Press, 1995), pp. 199-209, p. 200; Bornstein, 'Non-Standard Methods', p. 330-331.

⁹² Gerhard Fink and Peter Haiss, 'Seven Years of Financial Market Reform in Central Europe', in *Corporate Governance in Central and Eastern Europe: Transition Management is a Tough Job*, edited by Debora Revotella, Peter R. Haiss and Gerhard Fink (Amsterdam: SUERF, 1998), pp. 57-91, p. 83.

⁹³ Roman Frydman and Andrzej Rapaczynski, 'Markets and Institutions in Large-Scale Privatization: An Approach to Economic and Social Transformation in Eastern Europe', in *Reforming Central and Eastern European Economies: Initial Results and Challenges*, edited by Vittorio Corbo, Fabrizio Coricelli and Jan Bossak (Washington: The World Bank, 1991), pp. 253-274, p. 270.

⁹⁴ Frydman and Rapaczynski, 'Industrial Reform' [n.p.]; Jan Mladek and Iraj Hashi, 'Voucher Privatisation, Investment Funds and Corporate Governance in Czechoslovakia', *British Review of Economic Issues*, 15 (37) (1993), 67-95, p. 69; Klaus, *Ekonomické Teorie*, p. 12; Jiri Pehe, 'Czechs Fall From Their Ivory Tower', *Transitions* 4 (3) (1997), 22-27, p. 23.

influences on the outcomes, the way in which voucher privatisation operated is detailed below.

3.3.1 Participation In Voucher Privatisation.

Individuals participated in the voucher privatisation scheme by purchasing a booklet of vouchers denominated in various point values for Kč 35, which was then registered for Kč 1,000. As mass participation was one of the primary aims of this scheme these charges were only levied to cover administrative costs to prevent participation from being financially prohibitive for most eligible citizens.⁹⁵ Possessing significant amounts of accumulated income was generally regarded as an indication either of links to the KSČ or some form of illegal behaviour, so higher entry costs into the process would have been perceived as favouring those who had prospered under the previous regime.⁹⁶ It was also argued that the population had endured extensive, forced deferred consumption under the Communists to permit the accumulation of assets now being privatised. Consequently they should now be transferred to the population without their having to repurchase property that they were meant to already own, but which right had previously been

⁹⁵ Eligible participants in voucher privatisation were Czechoslovak citizens over 18 years of age. Josef C. Brada, 'The Mechanics of the Voucher Plan in Czechoslovakia', *RFE/RL Research Report*, 1 (17) (24 April 1992), 42-45, p. 43; Mladek, 'Different Paths', p. 131; John C. Coffee, 'Institutional Investors in Transitional Economies: Lessons from the Czech Experience', in *Corporate Governance in Central Europe and Russia, 1: Banks, Funds and Foreign Investors*, edited by Roman Frydman, Cheryl W. Gray and Andrzej Rapaczynski (Budapest: Central European Press, 1996), pp. 111-186, p. 123.

⁹⁶ Inotai, 'Experience with Privatization', p. 168; Timothy Ash, Paul Hare and Anna Canning, 'Privatisation in the Formerly Centrally Planned Economies', in *Privatisation and Regulation: A Review of the Issues*, edited by Peter M. Jackson and Catherine Price (Harlow: Longman, 1994), pp. 213-236, p. 220.

exercised by the state on their behalf.⁹⁷ Despite the political benefits of a free distribution of shares, a registration charge could perform a screening function and thus accelerate the development of a property-owning class.⁹⁸ However, the minimal fee in the Czech case is unlikely to have had much disincentive effect for any investors.⁹⁹

Large-scale voucher privatisation in Czechoslovakia and the Czech Republic occurred in two waves, with five and six rounds respectively. Registration for the first wave took place between November 1 1991 and February 17 1992. Vouchers could be deposited with IPFs between March 1 and April 26. Bidding began on May 18 and the fifth round of bidding ended on December 4 1992, with shares distributed on May 25 1993. In the second round, which applied only in the Czech Republic, registration occurred between October 1 and December 8 1993. Depositing shares with IPFs took place between December 15 1993 and March 9 1994. Bidding began on April 11 1994 and ended in late 1994, with share distributions from this round in early 1995.¹⁰⁰

Voucher points were used in bids for shares to determine their allocation amongst investors in the absence of an appropriate *a priori* valuation mechanism.¹⁰¹ All enterprise

⁹⁷ Jan Adam, *Social Costs of Transformation to a Market Economy in Post-Socialist Countries: The Cases of Poland, the Czech Republic and Hungary* (Basingstoke: Macmillan, 1999), pp. 174-175.

⁹⁸ Klaus, *O Tvář Zítřka*, p. 59.

⁹⁹ John S. Earle and Scott G. Gehlbach, *Privatization Policy Design and Popular Support for Reform in the Czech Republic*, 5th Nobel Symposium in Economics – The Economics of Transition, 10-12 September 1999 (Stockholm: SITE, 1999). 3 October 2000. <<http://www.hhs.se/site/Publications/No141web.pdf>>, p. 10.

¹⁰⁰ Kotrba, 'Privatisation Processes', p. 172.

¹⁰¹ For a detailed discussion of voucher privatisation in Czechoslovakia, from registration and bidding to share allocations, see Brada, 'Mechanics of the Voucher Plan', pp. 43-44; Frydman *et al*, *Privatization Process in Central Europe*, pp. 84-85; Coffee, 'Institutional Investors', pp. 118-145.

shares were initially assigned a “price” proportional to the book value of the firm¹⁰² to eliminate too wide a variation in returns to the constant set of voucher points available for individuals to invest, rather than allowing demand and supply to determine the initial prices. Vouchers could be offered in blocks of 1,000 points during a specified 2-week period for shares at this notional value. If excess demand was less than 25% of the total number of shares offered, the market was deemed to have cleared and all the shares are issued.¹⁰³ With excess supply, any shares bid for were issued and the remaining shares offered in a subsequent round at a lower price. No sales were made when excess demand exceeded supply by more than 25%. Instead a new issue was made at a higher price in subsequent rounds until a clearing price was achieved.

Generating activism by the population to become investors was a problem for the Czech government despite the low barriers to entry into this programme. Having no experience of active participation in enterprise monitoring, many saw few incentives to participation in voucher privatisation because they did not understand the role of shareholders, so the first deadline for registering voucher books had to be extended to increase participation.¹⁰⁴ Individual private investors faced weak incentives for participation because the costs of assimilating information limit their ability to make rational

¹⁰² Myant, *Transforming Socialist Economies*, pp. 241-242.

¹⁰³ Individuals have priority over intermediaries in the allocation of shares in this instance. Frydman *et al*, *Privatization Process in Central Europe*, p. 85; Mladek, ‘Different Paths’, p. 131.

¹⁰⁴ Coffee, ‘Institutional Investors’, p. 123; Bruno Dallago, ‘Between Spontaneity and Economic Engineering: Path Dependence in the Process of Economic Transition’, in *Economic Developments and Reforms in Cooperation Partner Countries: The Social and Human Dimension*, edited by Reiner Weichardt (Brussels: NATO Economic Directorate and Office of Information, 1997), pp. 73-86, p. 79.

investment decisions.¹⁰⁵ Until November 1991, only 25% of the eligible population expressed an interest in participation, compounded by the transformation bringing negative economic and social effects for much of the population in the short-run that did not encourage investment.¹⁰⁶ Incentives for participation only increased with the involvement of institutional intermediaries collectively representing shareholders, despite the intention for vouchers to encourage the emergence of financial markets, leading to one respondent to comment that

for most people the stock exchange was unknown and most did not want to participate and did not know what to do, so they gave them to the companies to invest as they knew what to do with them, just to get back their Kč 1,000 (Čísař 1, Trade Union President).

By spreading the risks of information collection, institutional investors eliminate prohibitively expensive information gathering and dissemination facing individuals and therefore facilitate post-privatisation restructuring.¹⁰⁷ They can derive economies of scale from this, creating sufficient incentives to exercise corporate governance.¹⁰⁸ Individual investors expect to benefit from the investment expertise of financial institutions, as

¹⁰⁵ Mladek and Hashi, 'Voucher Privatisation', pp. 68, 74.

¹⁰⁶ Cyril C. Ling, 'The Development of the Automobile Industry in Eastern Europe', in *Firm Behavior in Emerging Market Economies: Cases from the Private and Public Sectors in Central and Eastern Europe*, edited by Daniel S. Fogel (Aldershot: Avebury, 1995), pp. 23-52, p. 35.

¹⁰⁷ Paul J. J. Welfens, *Market-Oriented Systemic Transformation in Eastern Europe: Problems, Theoretical Issues and Policy Outcomes* (Berlin: Springer-Verlag, 1992), p. 124; David Ellerman, *Voucher Privatisation with Investment Funds: An Institutional Analysis*, Policy Research Working Paper, 1924 (Washington: The World Bank, 1998), p. 1.

¹⁰⁸ Mladek and Hashi, 'Voucher Privatisation', pp. 72-74.

intermediaries should be better placed to find and use information about enterprises than individuals, therefore following more rational investment strategies.¹⁰⁹

The Czech government did not set out to establish such intermediaries,¹¹⁰ envisaging that they would emerge as independent private institutions with incentives correspondingly different from those of the state privatisation agencies.¹¹¹ In the Czech case there were investment privatisation funds (IPFs) founded either by individuals or by investment companies (ICs), usually another financial institution or corporation.¹¹² Over 430 IPFs were established for the first wave of voucher privatisation, and an additional 120 for the second wave,¹¹³ although the number of founders was less since each could be licensed to sponsor more than one IPF, provided all legal requirements on their establishment were met.¹¹⁴ By January 1992 overall participation rates in voucher privatisation had risen to 55% and eventually reached 75% of the eligible population¹¹⁵ after some of the IPFs

¹⁰⁹ Roland Egerer, *Capital Markets, Financial Intermediaries, and Corporate Governance: An Empirical Assessment of the Top Ten Voucher Funds in the Czech Republic*, Policy Research Working Paper, 1555 (Washington: The World Bank, 1995), p. 3.

¹¹⁰ Kristin A. DeKuiper, 'The Development and Regulation of Investment Funds in the Czech and Slovak Republics: A Case Study on the Use of Intermediaries in the Privatisation Process', in *Privatization in Eastern Europe: Legal, Economic and Social Aspects*, edited by Hans Smit and Vratislav Pechota (Irvington-on-Hudson: Transnational Juris, 1994), pp. 74-91, p. 87; Michal Mejstřík, *Czech Investment Funds as a Part of Financial Sector and their Role in Privatization of the Economy*, Reform Round Table, Working Paper, 14 (Prague: Institute of Economic Studies, Charles University, 1994), p. 4.

¹¹¹ Frydman *et al*, *Capitalism With a Comrade's Face*, p. 26.

¹¹² Karla Brom and Mitchell Orenstein, 'The Privatised Sector in the Czech Republic: Government and Bank Control in a Transitional Economy', *Europe-Asia Studies*, 46 (1994), 893-928, p. 904; Egerer, *Capital Markets*, p. 6.

¹¹³ Cheryl W. Gray, *In Search of Owners: Lessons of Experience with Privatization and Corporate Governance in Transition Economies*, Policy Research Working Paper, 1595 (Washington: World Bank, 1996), p. 23.

¹¹⁴ Egerer, *Capital Markets*, p. 3; Coffee, 'Institutional Investors', pp. 124-126; Stijn Claessens, Simeon Djankov and Gerhard Pohl, *Ownership and Corporate Governance: Evidence from the Czech Republic*, Policy Research Working Paper, 1737 (Washington: The World Bank, 1997), p. 3.

¹¹⁵ Coffee, 'Institutional Investors', p. 123.

“monetized the gains and established a short-term profit that motivated citizens”¹¹⁶ by offering to buy back voucher booklets at a guaranteed price at a future date.¹¹⁷

The IPFs competed with each other to acquire voucher points from individuals who exchanged these for shares in the funds that then invested these points in privatising enterprises.¹¹⁸ These two avenues were not mutually exclusive and investors could at their discretion opt to directly invest any proportion of their voucher points individually and offer the remainder to the IPFs, so a lack of expertise did not preclude participation.¹¹⁹

As can be seen from Table 3.2, many investors opted to deposit at least some of their voucher points with the intermediaries, especially in the first wave. The smaller number of voucher points held by the largest ICs in the second wave partly reflects an increase in the number of intermediaries in existence, and that this wave did not occur in Slovakia. However, the total number of shares held by all intermediaries in the second wave was fewer, possibly indicating that investors preferred to invest directly in enterprises during this wave. This could reflect either dissatisfaction with the performance of the IPFs, or participants feeling that they had gained sufficient experience in the first wave and now preferred to select their own investment portfolios.¹²⁰

¹¹⁶ Coffee, ‘Institutional Investors’, p. 124.

¹¹⁷ Sweder van Wijnbergen and Anton Marcinin, *Voucher Privatization, Corporate Control and the Cost of Capital: An Analysis of the Czech Privatization Programme*, CEPR Discussion Paper, 1215 (London: CEPR, 1995), p. 21; Coffee, ‘Institutional Investors’, pp. 117, 124, 129.

¹¹⁸ Gray, *In Search of Owners*, p. 23; Claessens *et al*, *Ownership and Corporate Governance*, p. 3.

¹¹⁹ DeKuiper, ‘Development and Regulation’, p. 76; Laštovička *et al*, ‘Corporate Governance’, p. 200.

¹²⁰ Mejstřík, *Czech Investment Funds*, pp. 18, 20.

Table 3.2: Largest Investment Companies By Number of Voucher Points Collected.

First Wave ^a		Second Wave ^b	
Česká Spořitelna	950 million	Fondy Agrobanky	320 million
První Investiční	714 million	Expandia (Chemapol)	306 million
Harvard Capital and Consulting	639 million	Harvard Capital and Consulting	292 million
Všeobecná Úvěrová Banka Invest	501 million	Kvanto (ČS Obchodní Banka)	198 million
IKS Komerční Banka	466 million	KIS Česká Pojišťovna	187 million
KIS Česká Pojišťovna	334 million	IS Enterprises	157 million
Creditanstalt	220 million	YSE	156 million
Slovenské Investice	188 million	II. Czech Coupon Invest	152 million
VSŽ-Slovenská Sporitel'ňa	169 million	Česká Spořitelna	124 million
Prvá Slovenská Investičná	136 million	IKS Komerční Banka	124 million
První Privatizační Fond	118 million	Morce Investiční Společnost	113 million
Živnostenská Banka	118 million	První Privatizační Fond	>100 million
Slovenská Poist'ovňa	117 million	Investiční Banka	98 million
Agrobanka	112 million	CS Fondy	94 million
		Creditanstalt	>80 million
		Credit Suisse First Boston	70 million
		Trend	65 million
		Živnostenská Banka	60 million.
Total Number of Voucher Points	8541 million	Total Number of Voucher Points	6160 million

^aCzech and Slovak IPFs.

^bCzech IPFs only.

Sources: Brom and Orenstein, 'Privatised Sector in the Czech Republic', pp. 907, 910; Dlouhý and Mládek, 'Privatization and Corporate Control', p. 168; Otrádovec, *YSE Funds*, [n.p.].

That the institutional environment that IPFs and the firms they represent are situated within influences their practical impact has consequent implications for how restructuring proceeds in voucher privatised enterprises. The governance role of IPFs in post-privatisation restructuring of Czech enterprises is discussed further in the following chapter. The final section in this chapter considers the institutional framework for enterprise restructuring as the goal ultimately desired by Klaus' government for the voucher privatisation scheme.

3.4 INSTITUTIONAL INFLUENCES AND VOUCHER PRIVATISATION.

In order to ascertain the role that formal privatisation policies have in promoting restructuring in firms after privatisation, reference needs to be made to institutions because the

simultaneous restructuring of firms and reformulation of property and contracting rights may have less to do with the simple transfer of ownership from the state to private unitary actors than with the political deliberations about how risks and responsibilities will be borne by the actors, institutions and social relationships that have grown up around the assets into an economic whole.¹²¹

Neo-classical economic theory predicts that privatisation would alter the incentive structure facing actors linked to firms so that they respond to economic stimuli to achieve greater efficiency. Constraints in the institutional environment can limit the anticipated benefits of privatisation, whether because of failings in the design of the privatisation process or because of other inherited conditions, and the extent to which these could affect the design and application of privatisation in the Czech Republic are the concern of the remainder of this chapter.

¹²¹ McDermott, 'Renegotiating the Ties that Bind', p. 76.

In deciding how the privatisation process should be organised in transformational economies, state involvement may be promoted to ensure that the state retains control over the transformation as a whole. Alternatively, advocates of free-markets look to the failings of attempts to impose economic systems and claim that as markets emerge spontaneously, privatisation should be driven by demand and supply.¹²² Regardless of which approach guides privatisation, in practice the role of the state is crucial in determining the outcome of privatisation and restructuring of enterprises. This is not only through the establishment of policies and institutional arrangements, but also in ensuring that these function effectively and the legal provisions embodied within them are upheld. State involvement in privatisation is therefore required, whether the programme is government- or market-led. Legislation in the economy consequently provides an important formal institutional influence on the scope of privatisation and restructuring, with informal institutions and the enforcement aspect of these consequent in part on state intervention. This is part of a more generic reality that the outcomes of post-privatisation restructuring are conditional on the institutional environment within which they occur, and for understanding this, the embedded institutionalism framework has been developed in this work.

With government-led privatisation a central agency is charged with restructuring enterprises into a form potentially viable in a market environment before selling them to core investors with a long-term commitment to investment and future restructuring. This

¹²² Keith Grime and Vic Duke, 'A Czech on Privatization', *Regional Studies*, 27 (1993), 751-757; pp. 752-753.

is the model of the German Treuhandanstalt, which employed extensive state and institutional intervention for pre-privatisation restructuring.¹²³ The emphasis on restructuring is supported with financial assistance and other expertise from the former West Germany.¹²⁴ Adopted under very specific circumstances, this has not been used elsewhere.¹²⁵

Market-led models at the other extreme use sales of shares or property to distribute assets. A version of this approach has been adopted for the Czech Republic where the architects of the programme intended there to be minimal intervention by the state. Privatisation was applied to the vast majority of formerly state-owned enterprises in Czechoslovakia and the Czech Republic because of Klaus' belief in this as a means to encourage the emergence of a dynamic market economy¹²⁶ comprising efficiently owned and structurally organised enterprises. In principle, the assets of enterprises accepted for large-scale privatisation were passed from the founding ministry to the Fund of National Property (NPF) of the Czech or Slovak Republics.¹²⁷ The enterprises so controlled were meant to be privatised fully within 5 years, with the NPF taking responsibility for governance in the intervening period and having an ownership role once partial privatisation has occurred.¹²⁸

¹²³ Wendy Carlin and Colin Meyer, 'Restructuring Enterprises in Eastern Europe', *Economic Policy*, 15 (1992), 311-352, p. 313.

¹²⁴ Ash *et al*, 'Privatisation in the Formerly Centrally Planned Economies', p. 218.

¹²⁵ Lavigne, *Economics of Transition*, p. 160.

¹²⁶ David Stark, 'Path-Dependence and Privatization Strategies in East Central Europe', *East European Politics and Society*, 6 (1992), pp. 17-54, p. 23.

¹²⁷ These replaced the Federal Fund of National Property, established by Act 92/1991 for the same purpose.

As this thesis shows, institutional constraints mean that unlike the predictions of neo-classical economics based on frictionless markets, subsequent enterprise restructuring is not guaranteed after privatisation. Privatisation is not a panacea to alter expectations and mentalities, as privatisation policies only deal with the transfer of assets. Path-dependency and embeddedness ensure that the actual outcomes in firms depend on the influence of legacies and persistent mentalities of actors involved in privatisation and restructuring, as well as the conditions into which privatisation is introduced.¹²⁹

The effectiveness of privatisation within transformation therefore needs to be defined according to its ability to create dynamic and responsive firms from the ruins of the centrally planned economy. While voucher privatisation was envisaged as potentially encompassing all the assets of firms listed for inclusion in this scheme, a more common response in Czechoslovakia and the Czech Republic was a division of firms into smaller units for privatisation. This was to become more popular in the second wave and increased the complexity of the programme, despite an increased homogenisation in the firms included in the programme following the secession of the Slovak Republic and exclusion of firms located there,¹³⁰ an example of actual conditions in the economy required that “voucher fundamentalism was relaxed, allowing other modes of privatization and hence a more flexible programme.”¹³¹

¹²⁸ Frydman *et al*, *Privatization Process in Central Europe*, pp. 72-74.

¹²⁹ Edward J. Green, ‘Privatization, the Entrepreneurial Sector, and Growth in Post-Comecon Economies’, *Journal of Comparative Economics*, 17 (1993), 407-417, p. 413.

¹³⁰ Kotrba, ‘Privatisation Processes’, p. 175.

Institutional changes are required if privatisation is to be effective as a policy of transformation as well as in promoting restructuring¹³² since

within the prevailing state property, the measures and steps aimed at decentralization of decision-making processes cannot suffice to bring about the desired change in the pattern of behavior of producers.¹³³

The formal large-scale privatisation programme in Czechoslovakia was not implemented until 1991, so inevitable changes in the structure of the economy preceded this programme. These included the spontaneous emergence of an endogenous private sector comprising smaller firms, shifts in the product mix away from that artificially determined under central planning, and some redistributive flows of labour out of the labour force and to different uses as demand patterns altered.¹³⁴

Notwithstanding these changes, many formal and informal institutions from the centrally planned economy remained at the inception of privatisation. The effective introduction of privatisation policies that will encourage restructuring is dependent upon the institutional environment being supportive of the development of a market economic system.¹³⁵

Market structures inherited from the former system exhibited high degrees of concentration and monopoly. The sector studied in this thesis, manufacturing industry,

¹³¹ Dlouhý and Mládek, 'Privatization and Corporate Control', p. 157.

¹³² Dallago, 'Privatization', p. 35.

¹³³ Klaus, 'Main Obstacles', pp. 86-87.

¹³⁴ Bolton and Roland, 'Privatization Processes', pp. 285-286.

was structurally highly concentrated in Czechoslovakia in 1989, comprising very large and highly integrated enterprises developed to generate economies of scale. Such enterprises cannot compete effectively on world markets without restructuring because of their cumbersome internal and external configurations. An attendant change in the market structure that stresses demonopolisation rather than decentralisation, is necessary with privatisation if the economy is to be prevented from entering the "reform trap"¹³⁶ as ownership transfers through privatisation would otherwise simply replace one form of monopoly with another.¹³⁷ Competition could thus be institutionally restricted by their continued existence, unless such firms are sufficiently regulated to ensure that they operate in an efficient way, and the development and strengthening of competitive industrial and market structures occurs.¹³⁸

The design of voucher privatisation did incorporate some concessions to conditions in the Czech economy, especially the desire for strong domestic participation and the lack of finance necessitating a cheap distribution of shares. In this work though, it is proposed that many institutional influences on the design of the programme and the effects have been neglected. Crucially, voucher privatisation has not successfully generated incentives

¹³⁵ Ling, 'Development of the Automobile Industry', p. 35.

¹³⁶ Klaus, *A Road to Market Economy*, pp. 12-13.

¹³⁷ George B. Assaf, 'Enterprise Restructuring in Central and Eastern Europe and the Former Soviet Union: The Role of Technical Assistance', in *Privatization, Enterprise Development and Economic Reforms: Experiences of Developing and Transitional Economies*, edited by Paul Cook, Colin Kirkpatrick and Frederick Nixon (Cheltenham: Elgar, 1998), pp. 129-149, p. 129.

¹³⁸ Paul Starr, 'The New Life of the Liberal State: Privatization and the Restructuring of State-Society Relations' in *The Political Economy of Public Sector Reform and Privatization*, edited by Ezra N. Suleiman and John Waterbury (Boulder: Westview Press, 1990), p. 22-54, pp. 30-31; Blommestein *et al*, 'Privatising Large Enterprises: Overview of the Issues and Case Studies', in *Methods of Privatising Large Enterprises* (Paris: OECD/CCEET, 1993), 11-37, p. 20.

or restructuring because the programme is premised on a model inappropriate to the transformation conditions. The existence of institutional influences in the Czech environment therefore create unintended outcomes and eliminate the predictive function of neo-classical economics regarding expected restructuring outcomes subsequent to asset transfers through voucher privatisation.

3.4.1 Institutional Limitations to Voucher Privatisation in the Czech Republic.

As many firms need to acquire new funds in the short-term, restructuring of the financial sector, and particularly banks is an essential precondition for this. Share distributions following the completion of each wave of voucher privatisation have resulted in the emergence of embryonic stock and capital markets,¹³⁹ but these do not provide a realistic alternative to bank credit finance. Although there are three stock markets – the Prague Stock Exchange, the RM System and the Securities Centre – these have no common share price listings,¹⁴⁰ regulation of these capital markets is weak,¹⁴¹ and the dominant participants are domestic investors with limited capital resources.¹⁴² Share issues remain merely the technique by which property transfers are achieved, and have not promoted

¹³⁹ Klaus, *Ekonomické Teorie*, p. 37; Frydman *et al*, *Capitalism with a Comrade's Face*, p. 183; Andrew Spicer, Gerald A. McDermott and Bruce Kogut, 'Entrepreneurship and Privatization in Central Europe: The Tenuous Balance Between Destruction and Creation', *Academy of Management Review*, 25 (2000), 630-649, p. 632.

¹⁴⁰ Petr Chvojka, 'Financing Enterprise Restructuring', in *Industrial Competitiveness in East-Central Europe*, edited by Martin Myant (Cheltenham: Elgar, 1999), pp. 76-105, pp. 98, 99.

¹⁴¹ Debora Revoltella, 'Financing Firms in East European Countries: An Asymmetric Information and Agency Costs Approach', in *Corporate Governance in Central and Eastern Europe: Transition Management is a Tough Job*, edited by Debora Revoltella, Peter R. Haiss and Gerhard Fink (Amsterdam: SUERF, 1998), pp. 9-50, p. 44.

active ownership of firms.¹⁴³ Without any experience of stock markets, or an expectation that public information can or should be accurate, the anonymity of shareholding may have been a disadvantage in the programme, potentially exposing inexperienced investors to a high degree of risk.¹⁴⁴ Wide participation induced by low barriers to entry therefore was not certain to cause the emergence of an entrepreneurial class, with some investors only participating because they expected short-term financial gains from speculation.

Speed is seen as a positive attribute of mass privatisation programmes, minimising the opportunity for unregulated ownership transfers during the initial period of uncertainty.¹⁴⁵ In practice, an efficient, rapid privatisation is neither possible nor desirable¹⁴⁶ as demonstrated by voucher privatisation. Lobbying to gain preferential treatment may occur, and the stages of project approval, share allocation and subsequent distributions that needed to be undertaken individually for firms delayed privatisation in the Czech case.¹⁴⁷ However, the pace of privatisation is less important than the adaptations wrought in enterprises after ownership changes. One respondent perceived that privatising the firm through the voucher scheme meant

¹⁴² Mladek and Hashi, 'Voucher Privatisation', p. 68.

¹⁴³ Olivier Bouin, 'Privatization in Czechoslovakia', in *Constraints and Impacts of Privatization*, edited by V. V. Ramanadham (London: Routledge, 1993), pp. 115-138, p. 133; Mladek, 'Czech Companies', pp. 34, 44; Revoltella, 'Financing Firms', p. 34.

¹⁴⁴ Bouin, 'Privatization in Czechoslovakia', p. 135; Laštovička *et al*, 'Corporate Governance', p. 200.

¹⁴⁵ Jiří Večerník, 'Capitalist Renewal: Privatization and Business', in *Ten Years of Building Capitalism: Czech Society After 1989*, edited by Jiří Večerník and Petr Matějů (Praha: Academia, 1999), pp. 70-93, p. 77.

¹⁴⁶ Bolton and Roland, 'Privatization Processes', p. 287.

¹⁴⁷ Kotrba, 'Privatisation Processes', p. 169.

the chosen way was very quick but the penalty for this was that the quality of privatisation was lower than it could have been in other ways (Rukopis Strojírny 2, Operations Director).

More detailed consideration of these limitations of, and constraints on, owners as they specifically relate to the case study firms are discussed in the next chapter within the wider context of corporate governance and restructuring.

Privatisation can also theoretically eliminate or undermine expectations of support afforded to enterprise insiders by creating new owners with countervailing interests to those of the incumbent management acting in accordance with the principles of state ownership.¹⁴⁸ Klaus hoped that rapid privatisation would prevent the *nomenklatura* from taking advantage of their positions that reflected privileges inherited from the former regime,¹⁴⁹ and avoid the symbiosis between politics and economics being replicated.¹⁵⁰ Privileges were not formally extended to enterprise insiders through the Czech privatisation scheme,¹⁵¹ so there should not be problems with insider control creating obstacles to the replacement of ineffective managers.¹⁵² Yet incumbent managers

¹⁴⁸ Thomas, 'Politics and Economics', [n.p.].

¹⁴⁹ Kupka, 'Transformation of Ownership', pp. 306, 309.

¹⁵⁰ Kiss, 'Privatization Paradoxes', pp. 148-149.

¹⁵¹ Olivier Blanchard, 'Theoretical Aspects of the Transition', *American Economic Review*, 86 (2) (1996), 117-122, p. 121; Stijn Claessens and Simeon Djankov, 'Enterprise Performance and Management Turnover in the Czech Republic', *European Economic Review*, 43 (1999), 1115-1124, p. 1116.

¹⁵² Masahiko Aoki and Hyung-Ki Kim, 'Corporate Governance in Transition Economies', *Finance and Development*, 32 (3) (1995), 20-22, p. 20; Martin Myant, 'Czech Enterprises: The Barriers to Restructuring', *Prague Economic Papers*, 8 (1999), 163-177, pp. 164-165.

endeavoured to exploit the voucher privatisation programme, and remain in power.¹⁵³

Many of them did not regard the outcomes of voucher privatisation as a threat to their ability to control the firm in the post-privatisation era. Little new discipline was likely to be imposed on them through this as the new beneficiaries of reform are more dispersed than traditional interest groups.¹⁵⁴ With an element of flexibility on whether some assets could be included in the large or small-scale privatisation, it is possible that managers therefore preferred voucher privatisation for non-altruistic reasons, for although

the auctions of the small-scale privatization endangered management positions, the large-scale privatization offered a palatable alternative, transforming formerly state-owned companies into joint-stock companies that made it possible for managers to retain their positions.¹⁵⁵

The Czech privatisation programme also enabled the incumbent management to attempt to maximise its personal gain or generate support from the effective holders of power, the workforce, through spontaneous privatisation. A semi-legal version involves the incumbent management attempting to take control of the firm with the support of its

¹⁵³ Mladek, 'Different Paths', p. 137; Miklós Szanyi, 'Ownership Change and Performance in Companies of the Former Socialist Countries of Europe', in *Changes and Challenges: Economic Transformation in East-Central Europe*, edited by Pál Gáspár (Budapest: Akadémiai Kiadó, 1995), pp. 119-131, p. 128.

¹⁵⁴ Jan Winiceki 'Obstacles to Economic Reform of Socialism: A Property Rights Approach', *Annals of the American Academy of Political and Social Science*, 507 (1990), 65-71, p. 65; Roman Frydman and Andrzej Rapaczynski, 'Insiders and the State: Overview of Responses to Agency Problems in East European Privatizations', *Economics of Transition*, 1 (1993), 39-59, p. 51; Rumen Dobrinsky, 'Enterprise Restructuring and Adjustments in the Transition to Market Economy: Lessons from the Experience of Central and Eastern Europe', *Economics of Transition*, 4 (1996), 389-410, pp. 398, 402.

¹⁵⁵ Ježek, 'Czechoslovak Experience', p. 483.

workforce,¹⁵⁶ but this strategy can be detrimental to successful restructuring.¹⁵⁷ The basic approach is then for the incumbent management and other members of the *nomenklatura* to try and exploit their previously privileged position to gain *de facto* control over previously state-owned assets in order to be identified as the incumbent management and legal owners when property rights are allocated, and to appropriate these for their own purposes. The firm then enters a period of “pre-privatisation agony”, being a phase of inaction where the incumbent management focus only on short run aims of survival and undertakes no long term changes or improvements in the anticipation of the arrival of new owners.¹⁵⁸ This could be used as a cover to deliberately manipulate a decline in the firm’s output and asset value, enabling the management to acquire the firm through privatisation at a discounted price.¹⁵⁹ Similarly, if financial assistance from the state or closure of the firm in the future is expected, imposing financial discipline can become more difficult even after privatisation,¹⁶⁰ for example with wages in excess of productivity being paid.

¹⁵⁶ Roman Frydman and Andrzej Rapaczynski, *Privatization and Corporate Governance in Eastern Europe: Can a Market Economy be Designed?*, Economic Research Reports, 52, C. V. Starr Center for Applied Economics (New York: Department of Economics, New York University, 1991), pp. 25-25.

¹⁵⁷ Igor Filatotchev, Trevor Buck and Mike Wright, ‘Privatisation and Buy-Outs in the USSR’, *Soviet Studies*, 44 (1992), 265-282, p. 268.

¹⁵⁸ Martin Myant, ‘Problems of Transition in Eastern Europe - Should We Seek Alternatives?’, *British Review of Economic Issues*, 15 (37) (1993), 9-32, pp. 28-29.

¹⁵⁹ Alena Nešporová, ‘Industrial Restructuring in Czechoslovakia after 1989’, in *Industrial Restructuring and Trade Reorientation in Eastern Europe*, edited by Michael A. Landesmann and István P. Székely (Cambridge: Cambridge University Press, 1995), pp. 181-212, p. 188; Roman Češka, ‘Corporate Governance, Restructuring, Accountability: The Czech Republic’s Experience’, in *Trends and Policies in Privatisation*, 3 (1) (1997), 117-132, p. 125; Kristian Palda, ‘Czech Privatisation and Corporate Governance’, *Communist and Post-Communist Studies*, 30 (1997), 83-93, pp. 89, 91; Michal Mejstřík, ‘The Restructuring After Privatization in the Czech Republic’, *Prague Economic Papers*, 8 (1999), 233-260, p. 241.

¹⁶⁰ Desai, ‘Reformed Banks’, p. 464.

Another possibility is asset stripping where the most profitable assets are re-deployed into either a private subsidiary or a new company, creating a devalued firm with depreciated assets. This original firm can then be re-acquired through a cheap sale, and re-capitalised after privatisation with its former assets, or simply left to go out of business.

Amongst the case study firms, only in Drazitest was there any direct evidence of spontaneous privatisation restructuring activities. Here, the managerial team had successfully bid for the most profitable section of the plant, and achieved this with wide employee participation in share ownership, and the acquisition of much of the original assets from the former Drazitest state-owned enterprise. The overall results in this case appear beneficial. This contrasts with Císař, which is increasingly facing difficulties in the long-term that could potentially relate to a managerial strategy that expects state assistance to be forthcoming. Employees of the firm gave implicit suspicions of this, but there was no concrete evidence of this. It does however confirm the influence of managers for privatisation and restructuring outcomes in the absence of credible owners.

The extent to which managers promote or hinder restructuring after privatisation is a function of their influence within the enterprise. In part determined by the ownership forms as discussed in the following chapter, the influence of managers is also dictated by the institutional environment as discussed in more detail in Chapter Five, where the incentive structures of managers in privatised firms is examined more extensively. It is shown that in the case study firms, weak ownership has promoted the role of managers in restructuring. However, in each case studied, this has resulted in the continued

development of the firm, rather than exploitation of its assets in the short-term. Whilst ensuring the immediate survival of these firms, the effectiveness from a restructuring perspective has been mixed, ranging from the proactive managerial takeover of Drazitest to more disguised managerial strategies of Císař. Nevertheless, observed restructuring does depend on the respective influence of all actors within the firm, and this is addressed in the following chapters by reference to the wider institutional environment of the case study firms.

3.5 CONCLUSION.

Privatisation can, according to neo-classical economic theory bring positive changes to the functioning of an economy, which was the intention of privatisation experiments of governments in the 1980s, and now for the transformational economies of Central and Eastern Europe.¹⁶¹ This visibly reduces the direct role of the government in economic activity, thus signalling that the rules of the market take priority over planning. The establishment of an ethos of popular capitalism can also be significant if it effects a shift in the population's mentality on the social or economic desirability of a given form of ownership, and the role of complementary institutions within a market economic system.¹⁶² However, in the medium to long-term new entrants become more important

¹⁶¹ Stuart W. Bell, *Sharing the Wealth. Privatization Through Broad-Based Ownership Strategies*, Discussion Paper, 285 (Washington: World Bank, 1995), p. 2.

¹⁶² Nikolaos T. Milonas, *Mass Privatization Methods and their Effects on Capital Market Institutions, Agency Relationships and Managerial Monitoring*, Working Paper, 50 (Leuven: LICOS Centre for Transition Economics, 1995), p. 7.

than privatisation *per se* for creating a private sector. The stress on designing and implementing privatisation by Klaus may therefore have been misplaced for the long-term transformation of the economy, and a more effective strategy have been to encourage the emergence of new, endogenous private firms.¹⁶³ All producers face institutionalised distortions in their external operating environment in the transformational economy, but restructured state-owned firms carry with them endogenous institutional limitations to economically efficient behaviour in their structures, trade links, and personnel that should constrain new private firms to a lesser extent.

As privatisation does not unambiguously result in greater economic efficiency, there is a need to establish why this was so strongly advocated as an integral aspect of the Czech transformation. To determine the appropriateness of the Czech approach to privatisation it is necessary to consider how far the Klaus government's aims to achieve a rapid and equitable privatisation led to restructuring and therefore furthered the transformation process. Despite admitting that some mistakes has been made with privatisation,¹⁶⁴ Klaus has described voucher privatisation as having rapidly and effectively achieved its aims, and produced an approach that is respected and reproduced globally.¹⁶⁵ However, this study argues that there is uncertainty over the outcomes and benefits of privatisation, demonstrating that interdependence between the economic and political aspects of transformation means that justification cannot be sought solely in one of these spheres.

¹⁶³ Murrell, 'Privatization Complicates the Fresh Start', *Orbis*, 36 (3) (1992). Academic Search Elite. EBSCO Publishing. 24 April 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

¹⁶⁴ Václav Klaus, *Česká Cesta* (Praha: Profile, 1994), pp. 61-62.

¹⁶⁵ Václav Klaus, *Nemám Rád Katastrofické Scénáře* (Ostrava: Sagit, 1991), p. 44; Václav Klaus, *Rok Málo*

Although neo-classical economic theory legitimised the use of privatisation, the experience of privatisation in the Czech Republic has shown that the institutional environment cannot be neglected if its impact on restructuring is to be understood. Characteristics of the capitalist system abolished by the communists such as free markets, flexible prices and fully prescribed property rights needed to be re-introduced to provide a foundation for new, economically-oriented production after privatisation.¹⁶⁶ It was also necessary to change the industrial structure of the economy, otherwise the privatisation of former state-owned enterprises would have simply created private monopolies, to the detriment of consumer welfare overall.

Klaus claimed a commitment to liberal politics and monetarist economic principles,¹⁶⁷ and used privatisation in Czechoslovakia and the Czech Republic to increase economic efficiency, reduce state subsidies, and bring a radical change in the socio-economic system.¹⁶⁸ The true passivity of the state as merely an overseer of the process though is debatable.¹⁶⁹ The prescribed neo-liberalism and restricted role of the state does not appear to have been strictly adhered to, for example through measures such as the softening of credit availability, and the debt consolidation programme for banks to prevent their failure and the repercussions of this throughout the economy. These measures suggest that instead, the political imperative of achieving some form of privatisation has been most important, and that the incentives this generates for

Či Mnoho v Dějinách Země (Praha: Repro-Media, 1993), p. 88.

¹⁶⁶ Joseph E. Stiglitz, *Whither Socialism* (Cambridge, MA.: MIT Press, 1994), p. 180.

¹⁶⁷ Frydman *et al*, *Capitalism With a Comrade's Face*, p. 22.

¹⁶⁸ Simoneti, 'Comparative Review', p. 90.

restructuring are less significant.

The resultant privatisation policies superficially appear to correspond with the advice received from Western economists, which could have arisen because

[a] measure adopted elsewhere can be imported more easily because it arrives wrapped in a certain legitimacy. It also helps the innovative image of a particular party in search of "new" solutions.¹⁷⁰

This alone, though is insufficient justification. Choices over privatisation policies also reflect the political need to appease different agents affected by the process.¹⁷¹ Potential actors include insiders (management, employees and the former *nomenklatura*), domestic outsiders (individuals, financial institutions and companies) and foreign investors. Restitution as a form of privatisation has been used as a way of distancing the reformers from the former regime and engendering a commitment to reform amongst the general population.

Although privatisation quickly solved the issue of unclear property rights, corporate governance issues still need to be resolved¹⁷² because

¹⁶⁹ Laštovička *et al*, *Privatization and Opening*, p. 3.

¹⁷⁰ Ezra N. Suleiman and John Waterbury, 'Introduction: Analyzing Privatization in Industrial and Developing Countries', in *The Political Economy of Public Sector Reform and Privatization* edited by Ezra N. Suleiman and John Waterbury (Boulder: Westview Press, 1990), pp. 1-21, p. 3.

¹⁷¹ Milonas, *Mass Privatization Methods*, p. 1.

¹⁷² Dallago, 'Between Spontaneity and Economic Engineering', pp. 79, 82.

voucher privatisation ... has left a complex and confusing ownership pattern and an emphasis on financial dealings and takeovers rather than productive investment ... but ... it is unclear ... that a different method of privatisation alone would have led to radically different results.¹⁷³

The effectiveness of this policy in introducing new owners able to restructure the firms and contribute to the transformation processes is also critical. Not only can the incentives facing different principals vary according to their objectives as owners, but also the incentives of any one type of owner can differ across firms, according to their ownership share or objectives for the particular firm. Accordingly, the restructuring outcomes in any firm can only be accounted for empirically, by considering the aims and motives of all those involved in privatisation and subsequent restructuring. Corporate governance represents the mechanisms of control over the firm by owners as a determinant of restructuring choices and is discussed in the following chapter in order to assess the effectiveness of privatisation in creating new owners with adequate incentives to undertake restructuring.

¹⁷³ Martin Myant, *Where is the Economic Transformation Going?*, Paper at What's Going On in the Czech Republic? Conference, Central European Research and Development Unit, University of Glasgow, 14 March 1997. 4 August 2000. <<http://www2.arts.gla.ac.uk/Slavonic/staff/Myant.html>>, [n.p.].

CHAPTER FOUR

CORPORATE GOVERNANCE AND RESTRUCTURING

Once asset transfers had been achieved through privatisation, the Klaus government anticipated that the altered incentive structure would cause new owners to emerge and undertake restructuring. As this thesis has already argued, institutional influences determine how the implementation of privatisation occurs and the resulting outcomes arise. This chapter addresses the issue of whether owners emerging from voucher privatisation have sufficient incentives and opportunities to perform the necessary and desirable restructuring of firms after privatisation of former state-owned enterprises. Specifically, this chapter argues that in the absence of effective corporate governance, contrary to the government's expectations derived from neo-classical economics, new owners emerging after voucher privatisation do not necessarily initiate restructuring. It is shown that this is because they lack the incentives, and in particular the control rights to do this, as a consequence of the way corporate governance mechanisms have developed and operate in the Czech Republic after voucher privatisation.

The chapter begins by considering the nature of corporate governance and how this relates to post-privatisation restructuring under transformation conditions. The remainder of this chapter illustrates theoretical aspects of corporate governance with evidence from the restructuring in the case study firms, and the way in which corporate governance is developing in response to the institutional conditions created by voucher privatisation. The issue of bankruptcy however is specifically addressed in the first section. A distinct overarching institutional aspect of corporate governance

in any economic system, it has been difficult to introduce and use this in the Czech Republic.

The chapter continues by discussing the emergence of corporate governance after privatisation in the Czech Republic. There are *a priori* contradictory pressures on the development of corporate governance because of the historical development of the economy, particularly under communism, that restricted the extent of financial institutions and the shareholder based approach to corporate governance of voucher privatisation. Bank- and market-based corporate governance models as archetypes of corporate governance currently operating in other countries are reviewed, and their features contrasted with the corporate governance appropriate to the ownership patterns emerging in Czech firms. The experiences of privatisation and subsequent restructuring in the case study firms are used to illustrate how the adoption and implementation of governance mechanisms for Czech voucher privatised firms has occurred. The particular role of boards, institutional investors, and share consolidation in the context of voucher privatisation are presented, with the respective influence of each dependant upon and derived from, the institutional environment of voucher privatisation.

The chapter demonstrates that there are institutionalised difficulties for owners to exercise corporate governance within voucher privatised firms because of owner dispersal, limited financial resources, and remoteness from the firm that in many cases has been institutionalised through voucher privatisation. Limitations deriving from institutional influences, particularly the contradictions between the legislation and the practical implementation of voucher privatisation, have led to hybrid governance

conditions in privatised enterprises. It is shown that the heterogeneous ownership patterns arising from voucher privatisation are not directly compatible with the wholesale adoption of either of the two archetypes. Transplanting any corporate governance model into the uncertain and unique environment of Central and Eastern Europe would need to undergo such extensive modifications that the outcome of this could not be determined in advance.¹ As such, the emerging corporate governance in Czech enterprises reflects adaptations to the institutional environment actually existing. The chapter concludes by discussing the implications of current developments in influencing the future direction of corporate governance in Czech firms. Due to the uniqueness of voucher privatisation and the institutional environment in the Czech Republic, it is necessary for a system of corporate governance to develop that reflects the institutional environment facing voucher privatised enterprises.

4.1 CORPORATE GOVERNANCE AND TRANSFORMATION.

Corporate governance is the formal mechanism through which those with ownership rights should be able to exercise control within their enterprises to ensure that agency problems, which arise from owners and managers having differing goals, are overcome to the satisfaction of the owner. Owners differ in the ways they perform governance because of their own characteristics, as well as the institutional environment within which they act. Socialist ownership generated a "misalignment of governance" because control rights were implicitly allocated to the state through the

¹ Roman Frydman and Andrzej Rapaczynski, *Privatization and Corporate Governance in Eastern Europe: Can a Market Economy be Designed?*, Economic Research Reports, 52, C. V. Starr Center for Applied Economics (New York: Department of Economics, New York University, 1991), pp. 14-17.

subordination of other goals of owners and managers to plan fulfilment.² With private property, corporate governance has to be developed so that owners and managers have adequate power and scope to control asset use effectively, whilst fulfilling their responsibility to investors in the enterprise.³ Ownership forms determine the appropriateness of particular corporate governance mechanisms, but the precise ownership and structure of Czech enterprises is often unclear after voucher privatisation. A number of interim forms of corporate governance are therefore likely to be exhibited during transformation because the economic system and the broader institutional context of firms do not exhibit stability,⁴ resulting in continually changing demands that corporate governance should resolve.

In addition to being embedded in their contemporary context,⁵ corporate governance solutions are path-dependent, with strong historical precedents explaining the occurrence of opposing institutional corporate governance models.⁶ Corporate governance develops in accordance with perceptions of who should benefit from their relationship to an enterprise. Traditionally, economic theory assumes shareholders to

² Bob Garratt, 'Directing and the Learning Board', in *East-West Business Collaborations*, edited by Max Boisot (London: Routledge, 1994), pp. 7-23, pp. 10-11, 20-21; Daniel S. Fogel, 'Introduction' in *Firm Behavior in Emerging Market Economies: Cases from the Private and Public Sectors in Central and Eastern Europe*, edited by Daniel S. Fogel (Aldershot: Avebury, 1995), pp. 1-19, p. 10.

³ Margaret M. Blair, *Ownership and Control: Rethinking Corporate Governance for the Twenty-First Century* (Washington D.C.: Brookings Institution, 1995), p. 19; Elaine Sternberg, *Corporate Governance: Accountability in the Market Place*, Hobart Economic Paper, 137 (London: Institute of Economic Affairs, 1998), p. 20.

⁴ Adolf A. Berle and Gardiner C. Means, *The Modern Corporation and Private Property* (New York: Macmillan, 1933), p. 69; Blair, *Ownership and Control*, pp. 28-29.

⁵ Erik Berglöf, 'Capital Structure as a Mechanism of Control: A Comparison of Financial Systems', in *The Firm as a Nexus of Treaties*, edited by Masahiko Aoki, Bo Gustafsson and Oliver E. Williamson (London: Sage, 1990), pp. 237-262, p. 254; Kevin Keasey and Mike Wright, 'Issues in Corporate Accountability and Governance: An Editorial', *Accounting and Business Research*, 23 (Special Issue) (1993), 291-303, p. 302.

⁶ Andrei Shleifer and Robert W. Vishny, 'A Survey of Corporate Governance', *Journal of Finance*, 52 (1997), 737-783, p. 750; Oliver E. Williamson, 'Corporate Finance and Corporate Governance', *Journal of Finance*, 43 (1998), 567-591, pp. 588-589.

be residual claimants,⁷ but increasingly competing arguments are being proposed for enterprises to develop “social responsibility” and give control to other interest groups.⁸ By encouraging competitive behaviour by enterprises, releasing managers to perform their specialised functions, and ensuring both informal and legal accountability of managers to others with vested interests in the firm, corporate governance should complement rather than supplant managerial functions.⁹ Corporate governance in transformation economies has to overcome perceptual and behavioural legacies where the authority of principals over agents has not been recognised, as well as defining newly created control rights in enterprises. Corporate governance is thus inextricably linked to, although separate from privatisation. The aims for corporate governance therefore need to be established in transformation economies before a suitable legal and regulatory infrastructure to support this can be developed.¹⁰

Specificities of privatisation processes and subsequent adaptations within individual enterprises allow for the possibility of a novel form of corporate governance to emerge in the Czech Republic.¹¹ The main theoretical argument to mitigate against this is the apparent similarity in organisational forms evolving after privatisation in comparison to those in developed market economies that have emerged over a longer period of time. Since corporate governance is applied at the enterprise level,

⁷ Berle and Means, *Modern Corporation*, p. 355.

⁸ Blair, *Ownership and Control*, pp. 27, 203.

⁹ Blair, *Ownership and Control*, p. 3; Jonathan Charkham, ‘Corporate Governance and Competitiveness: The Main Principles’, in *Competitiveness and Corporate Governance*, edited by Andrea Westall (London: IPPR, 1996), pp. 1-4, pp. 2-3.

¹⁰ Blair, *Ownership and Control*, p. 11; Stavros B. Thomadakis, *Long-Term Investment, Stable Governance and Financial Issues of Privatization in Transition Economies*, Working Paper, 51 (Leuven: LICOS Centre for Transition Economics, 1995), p. 14.

¹¹ Rainer Gesell, *Corporate Governance Issues in the Polish Mass Privatisation Program*, International Workshop on Transition and Enterprise Restructuring in Eastern Europe, 20-22 August 1998

techniques that have previously proved themselves durable and compatible with given organisational forms in other countries are most likely to succeed in the transforming economies if such enterprise structures emerge here.¹² This chapter understands the emerging patterns of corporate governance through embedded institutionalism, arguing that conditions in the surrounding environment will affect the appropriateness of corporate governance mechanisms to particular firms.

Corporate governance procedures can be internal and firm-specific, or external measures that typically operate when internal methods fail and ownership changes result.¹³ Corporate finance, board structures, and shareholder monitoring by individuals and institutional investors are the primary internal corporate governance mechanisms in developed market economies. Their impact is discussed in the following sections of this chapter, because as transformation aims to move the economy towards this type of economic system, they are likely to be the most relevant mechanisms for exercising corporate governance in privatised Czech firms. They are also the mechanisms of corporate governance used by the case study firms, and so their restructuring impact within these firms is shown. Before considering these, however, bankruptcy, as the principal external corporate governance procedure, is described briefly. Whilst none of the case study firms have been subject to this extreme instrument of external governance, it remains an important aspect of the institutional framework for post-privatisation restructuring within Czech firms.

(Copenhagen: CEES/Copenhagen Business School, 1998). 25 September 2000.
<<http://www.econ.cbs.dk/institutes/cees/workshop/pdf/Gesell.pdf>>, p. 9.

¹² Roman Frydman, Cheryl W. Gray, and Andrzej Rapaczynski, 'Overview of Volumes 1 and 2', in *Corporate Governance in Central Europe and Russia, 1: Banks, Funds and Foreign Investors*, edited by Roman Frydman, Cheryl W. Gray and Andrzej Rapaczynski (Budapest: Central European University Press, 1996), pp. 1-19, p. 4.

4.1.1 Bankruptcy.

Corporate governance is meant to encourage efficient behaviour in firms and by implication, financial propriety with restructuring. Nonetheless, if an enterprise does experience financial distress and bankruptcy results, competing claims on the enterprise's remaining assets have to be legislated between to compensate investors in accordance with the risk embodied in their original investment.¹⁴ With bankruptcy, control passes to the firm's creditors. Although this gives an additional reason for banks to be seen as important governance agents in Czech firms,¹⁵ it is crucial to effective corporate governance in developed market economies.

Bankruptcy is an essential component of any market economy that enables uncompetitive firms to be replaced by more efficient ones. Legal provisions have been made for bankruptcy in the Czech Republic, but this is not a credible discipline for many privatised Czech firms because the persistence of state ownership with imperfections in the legislation, interlinkages of industry, and the potential socio-political consequences of widespread enterprise closures bring an expectation that these measures are politically too costly for the government to enact. Reticence in imposing bankruptcy was also part of the Klaus government's effort to help firms preserve the value of their assets, with subsidies and soft budget constraints through lax bankruptcy and inter-enterprise credit also extended to enterprises through

¹³ Charlie Weir, 'Corporate Governance, Performance and Take-Overs: An Empirical Analysis of UK Mergers', *Applied Economics*, 29 (1997), 1465-1475, pp. 1465-1466.

¹⁴ Blair, *Ownership and Control*, pp. 23-24.

¹⁵ Cheryl W. Gray, 'Creditors Crucial Role in Corporate Governance', *Finance and Development*, 34 (2) (1997), 29-32. 13 July 1999. <http://www.imf.org/external/pubs/ft/fandd/1997/06/pdf/gray.pdf>, p. 29.

continued state ownership in the immediate transformation period.¹⁶ This has remained one of the areas in which the governments have been able to retain some form of social policy essential to maintaining the support of the population for the continuation of reforms.¹⁷ In addition, the configuration of socialist industry means that bankruptcy of large firms is likely to reverberate through the economy, with the perception that this could lead to an economy-wide collapse.¹⁸

Whilst there are valid social, economic, and of course positive political reasons to delaying wide-scale bankruptcy,¹⁹ in combination these factors will normally result in non-efficient behavioural patterns and expectations being reinforced within firms.²⁰ Soft budget constraints were pivotal to the existence of many socialist firms, so new owners do not see an economic obligation to restructure and ensure the efficient operation of their firms without a credible bankruptcy discipline. Restructuring in healthier firms is also discouraged without this because such private firms face harder budget constraints as well as artificially inflated levels of competition. Without an enforceable threat of bankruptcy, the long-term institutional environment for

¹⁶ Aydin Hayri and Gerald A. McDermott, *Restructuring in the Czech Republic: Beyond Ownership and Bankruptcy*, Working Paper, 66 (Prague: CERGE, 1995), p.7; Jan Kláček and Vladislav Flek, *Company Restructuring: The Czech Experience*, Working Paper, 48 (Leuven: LICOS Centre for Transition Economics, 1995), pp. 16-17.

¹⁷ Richard Jackman, 'Economic Policy and Employment in the Transition Economies of Central and Eastern Europe: What Have We Learned?', *International Labour Review*, 133 (1994), 327-345, p. 331; John C. Ham, Jan Svenjar and Katherine Terrell, 'Unemployment and the Social Safety Net During Transitions to a Market Economy: Evidence from the Czech and Slovak Republics', *American Economic Review*, 88 (1998), 1117-1142, p. 1120.

¹⁸ Josef C. Brada, 'Privatisation is Transition - Or Is It?', *Journal of Economic Perspectives*, 10 (2) (1996), 67-86, p. 82; Carlo Sdravovich, 'Banks and Governance in Transition Economies', *Banco Nazionale del Lavoro Quarterly Review*, Special Issue: Property, Control and Corporate Governance of Banks, 200 (1997), 83-109, pp. 88, 105; Martin Myant, 'Transition in the Czech Republic', *Proceedings of the Scottish Society for Russian and East European Studies* (Glasgow: IREES, 1997), pp. 5-14, p. 9.

¹⁹ Kláček and Flek, *Company Restructuring*, pp. 16-18.

²⁰ David Stark and László Bruszt, *Postsocialist Pathways: Transforming Politics and Property in East Central Europe* (Cambridge: Cambridge University Press, 1998), pp. 155-156; Petr Chvojka, *Banking Sector's Role In Restructuring Of Central And Eastern European Economies: Case Study Of The Czech Republic* (Bratislava: Institute of Forecasting Slovak Academy of Sciences, 1997). 15 July 1999. <<http://progeko.savba.sk/6-74519975eng.htm>>, [n.p.].

restructuring in privatised firms is unfavourably skewed against this, which may have economically detrimental future effects.²¹ Its use in immature transformation economies should be guided by a consideration of the surrounding institutional environment of a firm and its operating conditions, but with a full realisation that postponing bankruptcy proceedings is not always beneficial to the economy's future development.

From the outset of the transformation, Czech commercial law has mirrored the German legal system²² in implicit recognition that a bank-based system inspired by the German model was expected to develop, and therefore that the legal framework should support bank involvement from the earliest possible time to allow them to acquire valuable experience in this role.²³ The bank-based model of corporate governance is presented below, and its relevance in encouraging restructuring by owners in Czech firms reviewed.

4.2 BANK-BASED CORPORATE GOVERNANCE.

Bank-based systems are usually associated with German and Japanese models of corporate governance. Both of these models are characterised by the presence of

²¹ Barbara Fakin, *Financial Institutions, Enterprise Investment Behaviour and Industrial Restructuring in Transition Economies*, Working Paper, 44 (Leuven: LICOS Centre for Transition Economics, 1995), p. 23; Klacek and Flek, *Company Restructuring*, p. 26.

²² Miriam Z Klipper, *The Governance of Privatized Firms: Problems of Power and Control*, Working Paper, 71 (Prague: CERGE, 1994), p. 17.

²³ Peter Dittus and Stephen Prowse, 'Corporate Control in Central Europe and Russia: Should Banks Own Shares?', in *Corporate Governance in Central Europe and Russia, 1: Banks, Funds and Foreign Investors*, edited by Roman Frydman, Cheryl W. Gray and Andrzej Rapaczynski (Budapest: Central European Press, 1996), pp. 20-67, pp. 62.

dominant, large shareholders²⁴ but important differences between these two variants remain, such as their dual and unitary board structure respectively.²⁵ Industrial organisation in each country also differs, which gives rise to some significant differences in the outworking of corporate governance. The Japanese version includes the *keiretsu*, an amalgamation of enterprises within an industrial grouping based on ties of monitoring and cross-ownership, centred around one dominant provider of financial services.²⁶ In this form priority is given to maximising returns to social capital.²⁷ Ownership and control over firms is stable because implicit agreement exists between most of the significant equity holders to relinquish the control rights that ownership construes.²⁸ Although institutional links between IPFs, banks, and enterprises in the Czech Republic may actually be tighter than those of the *keiretsu*,²⁹ this variant is not considered here to be applicable to the Czech case. Reflecting a particular development in response to specific historical and cultural conditions, it relies on a degree of loyalty and co-operation that is not likely to be emulated in any of the transformational economies, so this discussion concentrates on the German variant of the model that is partly emulated in the Czech Republic.

²⁴ Michael J. Rubach and Terrence C. Sebor, 'Comparative Corporate Governance: Competitive Implications of an Emerging Convergence', *Journal of World Business*, 33 (1998), 167-184. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

²⁵ Sternberg, *Corporate Governance*, p. 79.

²⁶ Stephen D. Prowse, 'Institutional Investment Patterns and Corporate Financial Behaviour in the US and Japan', *Journal of Financial Economics*, 27 (1990), 43-60, p. 46.

²⁷ Rubach and Seborua, 'Comparative Corporate Governance', [n.p.].

²⁸ Martha Prevezer and Martin Ricketts, 'Corporate Governance: The UK Compared with Germany and Japan', in *Capital Markets and Corporate Governance*, edited by Nicholas Dimsdale and Martha Prevezer (Oxford: Clarendon Press, 1994), pp. 237-256, pp. 245-246.

²⁹ Stark and Bruszt, *Postsocialist Pathways*, p. 159.

Bank-based models are optimal where the interests of various stakeholders have to be met.³⁰ They tend to emerge in loosely regulated environments where flexibility is accorded on the size of institutions, composition of portfolio holdings, and the involvement of outsiders and their subsequent role in share dealing if financial difficulties arise. The close connection between debtors and creditors means large shareholders with incentives to monitor firms to ensure they act in a consistent manner are common in bank-based systems.³¹ Generating enterprise capital relies primarily on internal methods such as retained profits and company-based contribution funds that reduce the necessity to resort to the market and external investors.³² Financial markets tend to be comparatively shallow in these countries, with additional finance obtained from shareholders who hold significant equity stakes in the company.³³ Risk is shared amongst creditors, which can generate complex interdependencies in the economy, but with enhanced direct control firms can more easily obtain credit, often at a preferential rate.³⁴ The close relationship between the firm and governance actors in bank-based systems brings significant benefits under conditions of uncertainty,³⁵ or where public information is scarce or unreliable, conditions prevalent in transformational economies.

Long-term realisation of a firm's objectives within the context of a complementary supporting institutional and economic culture is achieved with bank-based corporate

³⁰ Kevin Keasey and Mike Wright, 'Introduction: Corporate Governance, Accountability and Enterprise', in *Corporate Governance: Responsibilities, Risks and Remuneration*, edited by Kevin Keasey and Mike Wright (Chichester: Wiley, 1997), pp. 1-21, p. 12.

³¹ Jeremy Edwards and Klaus Fischer, *Banks, Finance and Investment in Germany* (Cambridge University Press, 1994), p. 194.

³² Ellen R. Schneider-Lenné, 'Corporate Control in Germany', *Oxford Review of Economic Policy*, 8 (3) (1992), 11-23, p. 13.

³³ Robert I. Mochrie, Mark E. Schaffer and Alan A. Bevan, 'Enterprise and Bank Restructuring in the Transition Economies', *Economic Survey of Europe*, 2 (1998), 33-66, p. 34.

³⁴ Berglöf, 'Capital Structure', pp. 237-238, 251.

³⁵ Keasey and Wright, 'Introduction', p. 13.

governance.³⁶ The literature frequently portrays the existence of a *hausbank* in the German model that enters into a working relationship with a firm, financing it during periods of temporary financial distress in anticipation of being free of competition from other banks should the firm become profitable later.³⁷ In practice, the perception of a *hausbank* may be misrepresentative. Banks are only one element in this relational system of corporate governance where commonality and deference to shared and competing interests of a number of agents, including banks and providers of other financial services, trade unions and employees, guilds and societies, shareholders and stakeholders all seeking for the enterprise to be governed in accordance with their own specific interests, have to be reconciled.³⁸

Whilst banks are achieving ownership in Czech firms, they are not necessarily adequately performing a governance role. This does not preclude the emergence of a bank-based system here in the future, since non-bank financial institutions were not developed under central planning, justifying the use of restructured banks as a primary source of enterprise finance.³⁹ To emerge as creditors with sufficient equity holdings to give incentives to undertake monitoring though, they needed to be reorganised and recapitalised through privatisation,⁴⁰ yet the development and reconstruction of the banking system in the Czech Republic has only occurred slowly in practice. Banks here are frequently unable to perform even the most fundamental banking functions

³⁶ Allen Sykes, 'Proposals for a Reformed System of Corporate Governance to Achieve Internationally Competitive Long-Term Performance' in *Capital Markets and Corporate Governance*, edited by Nicholas Dimsdale and Martha Prevezer (Oxford: Clarendon Press, 1994), pp. 111-127, p. 116; Rubach and Sebor, 'Comparative Corporate Governance', [n.p.].

³⁷ J. S. Edwards and K. Fischer, 'An Overview of the German Financial System', in *Capital Markets and Corporate Governance*, edited by Nicholas Dimsdale and Martha Prevezer (Oxford: Clarendon Press, 1994), pp. 257-283, p. 265.

³⁸ Schneider-Lenné, 'Corporate Control in Germany', pp. 15, 21; Shleifer and Vishny, 'A Survey', p. 739.

³⁹ Frydman *et al.*, 'Overview', p. 8.

⁴⁰ Mochrie *et al.*, 'Enterprise and Bank Restructuring', p. 56.

because of limited expertise in their human capital.⁴¹ Although this is true of most institutions in the domestic economy,⁴² in comparison with IPFs, the banks had much more information about many of their clients. The former branches of the state monobanks had pre-existing links to enterprises and some regional infrastructure through their inherited branch network. Even though the banks had gathered much of their information under the conditions of central planning, the slow pace of behavioural change means that this can still be a valuable resource to them during the transformation.

Bank owners should have a vested interest in the existence and improved economic situation of their firms, as these will become their future customers. Regardless of the legal corporate governance mechanisms in operation, banks can act as governance agents either directly as owners, or indirectly through lending to companies.

Theoretically, banks that acquire a good understanding of a firm's true financial position and its proposed future development can offer finance at more competitive rates than markets under conditions of economic uncertainty. This can facilitate restructuring, but credit provision should always be subject to active screening and monitoring. Banks need to take responsibility for monitoring their clients to ensure that owners and managers have incentives to act responsibly in strategic decision-making and avoid bank intervention or withdrawal of funding that could jeopardise their position. Reputation is also important to institutions in developed market economies since they often perform functions that are easily identified and monitored,

⁴¹ Leslie E. Grayson and Samuel E. Bodily, *Integration into the World Economy: Companies in Transition in the Czech Republic, Slovakia and Hungary*, Research Report 96-19 (Laxenburg: International Institute for Applied Systems Analysis, 1996). 27 August 1999. <<http://www.iiasa.ac.at/Publications/Documents/RR-96-019.pdf>>, [n.p.].

⁴² Dittus and Prowse, 'Corporate Control', pp. 55-56.

which requires them to act responsibly in order to secure their future earnings.⁴³ This should be replicated in the transformational economies where the banks are emerging as significant owners of firms and agents of enterprise restructuring. However, sufficient useful and accurate information is not always presented by Czech firms, which means judgements on lending by banks can be fundamentally flawed to the detriment of governance, and consequently restructuring.

The domestic banking sector already has an indirect ownership stake in many privatised enterprises in the Czech Republic through their ownership of IPFs as well as through outstanding debts, giving them an informational and participatory advantage over other newly emergent institutions in performing a governance role.⁴⁴ In addition, banks have performed some debt for equity swaps in an attempt to encourage enterprise restructuring,⁴⁵ which also represents their having already taken on some tasks associated with corporate governance.

To further support banks in their ownership and monitoring role a new state bank, Konsolidační Banka, was created in 1991 to purchase discounted bad debts and outstanding loans from the commercial banks. Alleviating the burden of bad debts on commercial bank lending and preventing the feared chain of bankruptcies was supposed to enable commercial banks to undertake new lending without having to finance a poorly functioning loan portfolio inherited from the centrally planned economic system.⁴⁶ Loan consolidation was critical to restructuring in privatised

⁴³ Bernard S. Black, 'Institutional Investors and Corporate Governance: The Case for Institutional Voice', *Journal of Applied Corporate Finance*, 5 (3) (1992), 19-32, p. 30.

⁴⁴ Dittus and Prowse, 'Corporate Control', pp. 58, 60.

⁴⁵ Dittus and Prowse, 'Corporate Control', pp. 58-59.

⁴⁶ Karla Brom and Mitchell Orenstein, 'The Privatised Sector in the Czech Republic: Government and Bank Control in a Transitional Economy', *Europe-Asia Studies*, 46 (1994), 893-928, pp. 900-901.

firms, since banks holding a large proportion of bad debts have few incentives to undertake more prudent lending in the future where bank supervision is weak as in the Czech Republic. Defaults at the margin then have only a limited effect on the overall asset quality of the bank's portfolio, and lending to inappropriate ventures with a high risk attached in the hope of strong returns to the bank if it was successful can occur more frequently.⁴⁷ Poorly capitalised banks and much uncertainty in the economic environment can result in high interest rates and shorter loan periods.

Long-term credits are most useful for restructuring purposes, but only account for around 30% of those issued to Czech firms.⁴⁸ However, Czech banks tend to offer credits for short or medium term financing because of their limited liquidity, suspicion of the creditworthiness of the borrowers, and inexperience in assessing borrowing proposals. Alternatively, banks will lend in preference to those firms able to put up greater amounts of collateral. Larger enterprises and those for whom budget constraints are not completely hardened through some residual state ownership meet these conditions most easily. This not only makes it more difficult for a new private sector to emerge, but also perpetuates the industrial networks that emerged during the communist era.⁴⁹

Although Konsolidační Banka became the main creditor to around 80% of medium and large privatised firms, and was supposed to take an active role in enterprise

⁴⁷ Dittus and Prowse, 'Corporate Control', p. 57; Sdravovich, 'Banks and Governance', pp. 88-89.

⁴⁸ Petr Chvojka, 'Financing Enterprise Restructuring', in *Industrial Competitiveness in East-Central Europe*, edited by Martin Myant (Cheltenham: Elgar, 1999), pp. 76-105, p. 95.

⁴⁹ Roman Frydman and Andrzej Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away?* (London: Central European University Press, 1994), pp. 130-131; Sdravovich, 'Banks and Governance', p. 89.

restructuring,⁵⁰ in reality the programme was not sufficiently comprehensive. It left many banks with continuing bad debts and an inability or unwillingness to initiate bankruptcy proceedings in the economically unstable environment, to the overall detriment of their own balance sheets. The effects of this can be to discourage restructuring because it is more difficult for owners to obtain new financial resources, with one respondent suggesting that

a strong influence on the debt problem is the unwillingness of banks to lend to companies – even fear – because of previous bad experiences. This is a problem for Rukopis Strojírny and there is a trickle-down effect problem for Odraz KM. Privatisation in the Czech Republic generated a lot of new owners here who do not want to do business but just to get loans from banks for their private use and not to repay the funds to the banks, which is the main reason why banks now are finding it difficult to survive (Odraz KM 1, Managing Director).

Certain conditions favourable to the emergence of a bank-based system existed in the Czech Republic but this has not been fully supported by institutional developments. Voucher privatisation created new shareholders and was to introduce an ethos of popular capitalism, suggesting that a more suitable model of corporate governance would be a market-based approach that gives shareholder interests priority. Such models have proven most appropriate in economies with rapid changes in technology and innovations in management systems,⁵¹ which means they could be optimal for

⁵⁰ Brom and Orenstein, 'Privatised Sector in the Czech Republic', pp. 894, 900-901.

⁵¹ Julian Franks and Colin Mayer, 'Capital Markets and Corporate Control: A Study of France, Germany and the UK', *Economic Policy*, 10 (1990), 191-231, p. 214; Keasey and Wright, 'Introduction', p. 12.

transformational economies that are operating under conditions of uncertainty. Risk is shared amongst external shareholders and creditors, but shareholders are residual claimants, so only after all other claims on the enterprises assets have been satisfied are they eligible for financial reward. To be effective, this type of corporate governance relies on large quantities of accurate information being publicly available, and the presence of investors with sufficient incentives and expertise to evaluate this information.⁵² These preconditions for effective market-based governance are difficult to attain in transformation economies, which additionally supports the appropriateness of a bank-based system.

Bank-based systems exhibit a greater degree of stability in ownership and control of enterprises than market-based ones,⁵³ which is particularly evident through their reliance on internal monitoring and the limited number of hostile takeover attempts because insiders easily oppose these.⁵⁴ They promote active monitoring because risk-bearing creditors have their interests closely tied to the success of the firm. Effective monitoring of firms can occur under bank-based systems because a degree of loyalty exists between the firm and its investors that can give them time to recover from a decline in efficiency, whereas the immediate economic status of the firm might require exit in a market-based system.⁵⁵ However, the equality of all shareholders is compromised since those closely involved in monitoring the firm acquire some status as insiders with access to privileged knowledge not necessarily publicly available.⁵⁶

Investors who take an interest in monitoring firms in market-based models are

⁵² Dittus and Prowse, 'Corporate Control', pp. 33-34; Sternberg, *Corporate Governance*, p. 72.

⁵³ Prevezer and Ricketts, 'Corporate Governance', p. 246.

⁵⁴ Franks and Mayer, 'Capital Markets and Corporate Control', p. 191.

⁵⁵ Albert O. Hirschman, *Exit, Voice and Loyalty: Responses to Decline in Firms, Organizations, and States* (Cambridge, MA.: Harvard University Press, 1970), p. 79.

normally prohibited from future trading under fears of insider advantage, but this can impede flows of information between owners and shareholders and the management,⁵⁷ and engender inefficiency because of a lack of close shareholder monitoring.

Despite these limitations of market-based governance and the legislative support for a bank-based model in Czech enterprises, the voucher privatisation scheme and its intended objectives are contradictory to those of bank-based models, being more compatible with a market-based system. The following section examines whether market-based corporate governance can develop as a form of corporate governance that will ensure restructuring occurs in enterprises after voucher privatisation in the Czech Republic.

4.3 MARKET-BASED CORPORATE GOVERNANCE.

An ability to defend one's rights is essential for any shareholder to exercise effective corporate governance. Where firms raise capital by issuing shares, the interests of shareholders as the ultimate owners of firms, should take priority in corporate governance.⁵⁸ With voucher privatisation, the government focused on asset transfers to change ownership, but little consideration was given to the impact of consequent share ownership patterns on restructuring in enterprises. Voucher privatisation produced dispersal between individual shareholders as typically arises where market-

⁵⁶ N. H. Dimsdale, 'The Need to Restore Corporate Accountability: An Agenda for Reform', in *Capital Markets and Corporate Governance*, edited by Nicholas Dimsdale and Martha Prevezer (Oxford: Clarendon Press, 1994), pp. 13-49, p. 31.

⁵⁷ Helen Short and Kevin Keasey, 'Institutional Shareholders and Corporate Governance', in *Corporate Governance: Responsibilities, Risks and Remuneration*, edited by Kevin Keasey and Mike Wright (Chichester: Wiley, 1997), pp. 23-60, p. 28.

⁵⁸ Prevezer and Ricketts, 'Corporate Governance', p. 244.

based governance methods are used.⁵⁹ As the holdings of any one individual usually represent only a small fraction of the firm's equity, undertaking monitoring can be prohibitively expensive for individuals.⁶⁰ As residual claimants, they are more likely to focus on short-term profits and high dividend payments than entering into long-term relationships with the firm,⁶¹ with the dispersal of shareholders impeding co-ordinated actions.

Nevertheless, shareholders are not necessarily ineffective in their dispersal for

[i]n a world in which self interest plays a significant role in economic behaviour, it is foolish to believe that owners of valuable resources systematically relinquish control to managers who are not guided to serve their interests.⁶²

Individuals act in their own interest to maximise their financial gains or discipline managers, regardless of whether this is rational in the aggregate.⁶³ The strategy adopted by shareholders is termed "exit", and occurs where

[s]ome customers stop buying the firm's products or some members leave the organisation. ... As a result, revenues drop, membership declines, and

⁵⁹ Sykes, 'Proposals', p. 114; Rubach and Sebor, 'Comparative Corporate Governance', [n.p.].

⁶⁰ Josef C. Brada, Alexandra Hess, Inderjit Singh, 'Corporate Governance in Eastern Europe: Findings from Case Studies', *Post-Soviet Geography and Economics*, 37 (1996), 589-614, p. 595; Gray, 'Creditors Crucial Role', p. 29.

⁶¹ Brada, Hess and Singh, 'Corporate Governance in Eastern Europe', p. 594; Rubach and Sebor, 'Comparative Corporate Governance', [n.p.].

⁶² Harold Demsetz, 'The Structure of Ownership and the Theory of the Firm', *Journal of Law and Economics* 26 (1983), 375-390, p. 390.

⁶³ Ken Mayhew and Paul Seabright, 'Incentives and the Management of Enterprises in Economic Transition: Capital Markets Are Not Enough', *Oxford Review of Economic Policy*, 8 (1) (1992), 105-

management is impelled to search for ways and means to correct whatever faults have led to exit.⁶⁴

Managerial behaviour in market-based systems is constrained by accountability to shareholders who trade in stock markets to maximise their dividend payments⁶⁵ and through this indicate their satisfaction or complaint with the current practice of enterprise directors and management. If sufficient numbers of shareholders act consistently in the market, share prices will respond accordingly. Also, ownership change is often associated with this type of corporate governance, particularly through takeovers as a solution to managerial failure. In such cases, inefficient incumbents are replaced with the prospect of more efficient resource use occurring. The threat of takeovers is expected to motivate the management and employees to adopt more efficient behaviour,⁶⁶ although wherever the incumbent managers are also significant shareholders, they may be in position to block or hinder takeovers and other market-driven governance techniques.

Exit is only a suitable strategy if alternative buyers with incentives to monitor firms exist,⁶⁷ with additional complications if shareholders are institutional investors. These should be free to readjust their portfolios and maximise returns to their investors to whom they are primarily accountable to and whom can withdraw their funds if they are not satisfied with the institution's performance in monitoring,⁶⁸ but they may not have adequate incentives to do this. Markets are most likely to respond to negative

129, p. 107; Colin Mayer, 'Corporate Governance and Performance: The Evidence', in *Competitiveness and Corporate Governance*, edited by Andrea Westall (London: IPPR, 1996), pp. 17-23, p. 20.

⁶⁴ Hirschman, *Exit, Voice and Loyalty*, p. 4.

⁶⁵ Blair, *Ownership and Control*, p. 21; Mayer, 'Corporate Governance and Performance', p. 20.

⁶⁶ Franks and Mayer, 'Capital Markets and Corporate Control', pp. 191, 210, 214, 215; Dittus and Prowse, 'Corporate Control', p. 37.

disclosures with falling share prices, but as institutional investors are shareholders themselves this reduces the aggregate value of their portfolio holdings, creating a disincentive against the adequate enforcement of corporate governance discipline over managers.⁶⁹ In market-based systems, firms can thus be unwilling to disclose information as this can signal difficulties being experienced by the management and owners, and negatively affect share prices. In the Czech Republic, inexperience of investors and uncertainty from the transformational environment will compound these problems, which could exacerbate obstacles to restructuring.

The relationship between external investors and the incumbent management generates an agency problem that needs to be resolved by corporate governance,⁷⁰ so shareholder representation on enterprise boards is a key element of market-based corporate governance approaches. The structure of boards and the representation shareholders attain in their companies is important for understanding the incentives facing new owners in restructuring after privatisation because this defines their access to resources, and extent of control within the enterprise.⁷¹

⁶⁷ Mayhew and Seabright, 'Incentives and the Management of Enterprises', p. 111.

⁶⁸ Black, 'Institutional Investors and Corporate Governance', p. 30.

⁶⁹ Black, 'Institutional Investors and Corporate Governance', p. 29; Short and Keasey, 'Institutional Shareholders and Corporate Governance', pp. 28, 37-38.

⁷⁰ Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', *Journal of Financial Economics*, 3 (1976), 305-360, p. 309.

⁷¹ Shleifer and Vishny, 'A Survey', p. 755.

4.3.1 *Boards and Corporate Governance.*

The 1992 Czech Commercial Code requires a dual board structure in joint-stock companies.⁷² This comprises an executive board of shareholder-elected representatives that is responsible for day-to-day decision-making,⁷³ and a supervisory board to control the enterprise, with responsibility for ensuring the enterprise acts in compliance with legal requirements in its operation, and monitoring the enterprise management through the executive board.⁷⁴ In companies with more than 50 employees, two-thirds of the supervisory board are elected by the shareholders and one third by employees, whereas the executive board can be similarly elected at the AGM, or its members appointed by the supervisory board at the discretion of the individual enterprise.⁷⁵

A pattern emerging in the Czech Republic is one where the executive board is dominated by representatives of owners if they have a controlling influence within the firm, and otherwise they normally only achieve representation on the supervisory board.⁷⁶ The ability of the owners to influence restructuring decisions is more problematic in the latter case because their direct control over the way the firm is operated is emasculated. In Rukopis Strojírny the owner has representation on the executive board, and this is resented here by many of the executive directors because

⁷² Act 513/1991, *Obchodní Zákoník*; Brom and Orenstein, 'Privatised Sector in the Czech Republic', p. 910.

⁷³ Blair, *Ownership and Control*, p. 21.

⁷⁴ Schneider-Lenné, 'Corporate Control in Germany', p. 16.

⁷⁵ Brom and Orenstein, 'Privatised Sector in the Czech Republic', p. 910; Iraj Hashi, 'Mass Privatisation and Corporate Governance in the Czech Republic', *Economic Analysis*, 1 (1998), 163-187, p. 175.

⁷⁶ Brom and Orenstein, 'Privatised Sector in the Czech Republic', p. 911; Coffee, 'Institutional Investors', p. 150.

this circumscribes their independence. Describing this, one director spoke of his perception that this meant

when the owner has a plan for change that the directors don't agree with, the General Director has to follow this even if he is not happy with it, so it would be better if the owner had less control and not have the power to direct the directors (Rukopis Strojírny 8, Quality Director).

Another argued that owners should only have representation on the supervisory board so that they can be

actively interested in the company, not trying to direct the company but just to know the aims and problems and how these are being addressed by the other directors (Rukopis Strojírny 8, Quality Director).

The dual board structure can bring advantages because managers may have greater incentives to actively undertake monitoring to avoid intervention by the owners, but this enhances the shift in the locus of power away from the formal owners. If a firm has multiple large shareholders with significant equity holdings and divergent interests, the enterprise management can strengthen their position by setting these in competition against each other to gain managerial support, or by favouring those perceived to give the greatest advantages to the incumbents,⁷⁷ which is unlikely to be conducive to restructuring.

⁷⁷ Coffee, 'Institutional Investors', p. 154.

The function of the supervisory board in particular was seen by many respondents as obsolete or of limited value as in Drazitest where “the company is so small and all communicate with each other; the supervisory board is just a decoration that has to legally exist” (Drazitest 1, Quality Director), and similarly in Přesnost KM where

the function of the supervisory board is to supervise the work of the executive board, but it does not have any legal “power” to do anything (Přesnost KM 1, Financial Planning Manager).

In one case, the requirement of a dual board structure was criticised from a different perspective, with the respondent seeing a benefit from having the owners always present so that “where there are problems it is possible to get a co-ordinated response” (Rukopis Strojírny 2, Operations Director). However, this appears to be a theoretical, rather than a practical concern, with the predominant view of respondents in the case study firms indicating that the interests of managers and owners often diverge, and that such co-ordination is not sought.

Labour representation is also afforded an explicit role in the Czech legislation that is supposed to encourage a greater commitment to the firm in the long-term by the employees.⁷⁸ Labour representation can reduce the tendency to express dissatisfaction through strikes and other “shop-floor” actions. Having this at the level of the supervisory board accentuates the removal of labour interference in operational decisions, whilst increasing the strategic influence of labour concerns.⁷⁹ Owners may

⁷⁸ Mayhew and Seabright, ‘Incentives and the Management of Enterprises’, p. 114; Martin Ricketts, *The Economics of Business Enterprise: An Introduction to Economic Organisation and the Theory of the Firm*, 2nd edition (Hemel Hempstead: Harvester Wheatsheaf, 1994), p. 273.

⁷⁹ Mayhew and Seabright, ‘Incentives and the Management of Enterprises’, p. 114.

perceive this to hinder discussion or the adoption of necessary restructuring measures that would require substantial downsizing and reorganisation of the workforce,⁸⁰ whilst employees can see this as ineffective since “there is minimum influence by worker shareholders who are consulted at meetings, but managers have the last word” (Drazitest 3, Supplies Manager).

Shareholder representation is meant to encourage optimising behaviour by the incumbent management, but popular capitalism results in dispersed ownership that can be inefficient⁸¹ because the new owners may be too widely dispersed, disinterested, or inexperienced to extend effective ownership and corporate governance in firms they own.⁸² Respondents recognised institutional constraints dictate the effectiveness of shareholder representation, for whilst

success or failure is due to the directors and managers of the firm who are in turn responsible for the company to all its shareholders, in practice it does not work like this. Although the directors are responsible to all the shareholders by law, and although the shareholders can all be together at their AGM, they are never all together at one time. This is caused by the structure of shareholders and it not being a custom in the Czech Republic to get over 3000 people together in one place at one time. This means that the contemporary owner can

⁸⁰ Coffee, ‘Institutional Investors’, pp. 152, 154-155.

⁸¹ Jan Mládek, ‘Czech Companies after the First Wave of Voucher Privatisation: Was the Change Real or Formal?’, in *Privatisation in Visegrád Countries: Old Principles and New Methods*, edited by Miklós Szanyi, Proceedings of the International Conference (Budapest: Institute for World Economics, 1994), pp. 153-172, p. 160; Gesell, *Corporate Governance Issues*, pp. 7-8.

⁸² Hilary Appel, ‘Justice and the Reformulation of Property Rights in the Czech Republic’, *East European Politics and Societies*, 9 (1995), 22-40, p. 28; Bruce Kogut and Andrew Spicer, *Institutional Technology and the Chains of Trust: Capital Markets and Privatization in Russia and the Czech Republic*, Working Paper, 291 (Ann Arbor: Davidson Institute, 1999). 3 October 2000. <<http://www.eres.bus.umich.edu/docs/workpap-dav/wp291.pdf>>, p. 15.

be a majority owner even if they do not have more than 50% of the shares (Odráz KM 1, Financial Planning Manager).

As a result

individual shareholders do not go to the AGM because they do not have the power to make decisions. In a better situation they would have a union and one representative over them (Císař 1, Trade Union President).

In the Czech Republic shareholder rights have only been crudely prescribed⁸³ and enforcing shareholder protection is difficult, so “in no way do the directors have to act in the interests of the small, individual shareholders” (Císař 3, Retired Analyst).

Therefore,

voucher privatisation led to a lot of problems in the economy as some managers are only interested in getting money and really do not care about the company and business activities. They can do this as the shareholders cannot influence what happens in the company, but it depends on the capacity of the workers and how they work to solve the problems (Přesnost KM 1, Financial Planning Manager).

Where relative shareholder dispersal is the cause of agency problems, concentration is necessitated. One way for individual investors to overcome this limitation is to amalgamate their holding within an umbrella organisation so that as shareholders they

⁸³ Coffee, ‘Institutional Investors’, p. 167.

can gain board representative and directly express their collective interests.⁸⁴ This is a strategy of “voice” where

[t]he firm’s customers or the organization’s members express their dissatisfaction directly to management or to some other authority to which management is subordinate, or through general protest addressed to anyone who cares to listen. ... As a result, management once again engages in a search for the causes and possible cures of customers’ and members’ dissatisfaction.⁸⁵

Voice is consistent with long-term investment practices where shareholders do not constantly aim to maximise immediate profits by monitoring and readjusting their portfolio. Instead they are meant to offer advice and assistance in order that as many as possible of the enterprise’s goals are met simultaneously. Shareholders following a voice strategy are expected to acquire knowledge about the enterprise they monitor and be able to distinguish between a cyclical downturn and fundamental problems in a way that the market is less able to do. Where voice is the dominant strategy for expressing dissatisfaction with managerial behaviour, it is expected that there will be fewer and more active shareholders than where exit dominates, to make them “audible” to the management and directors.⁸⁶ It is therefore commonly associated with bank-based systems of Germany and Japan where the conditions for voice are easily met, but can also exist within market-based systems. In this latter case, the financially small and dispersed nature of individual shareholders means that institutional investors can be the only shareholders with sufficient equity holdings to

⁸⁴ Hilary Appel and John Gould, ‘Identity Politics and Economic Reform: Examining Industry-State Relations in the Czech and Slovak Republics’, *Europe-Asia Studies*, 52 (2000), 111-131, p. 114.

⁸⁵ Hirschman, *Exit, Voice and Loyalty*, p. 4.

exercise corporate governance effectively.⁸⁷ In the Czech Republic voice strategies are appropriate for institutional owners in exercising corporate governance, especially IPFs, yet as discussed below, their impact as governance agents can be ambiguous.

4.3.2 *Institutional Investors and Corporate Governance.*

With market-based corporate governance, institutional investors are external to the firm and they have to expend resources in acquiring information about the firms they monitor. Large shareholdings constitute the purchase of an expensive and durable good, and these few shareholders in a firm will be able to pursue a concerted action because their influence is sufficiently strong to induce changes in managerial actions.⁸⁸ This mirrors the behaviour of large shareholders in bank-based systems having control rights matched with cash-flow rights that give them an incentive to incur monitoring costs, particularly if they can gain economies of scale from doing this.⁸⁹ Institutional investors however do not unambiguously prefer voice to exit strategies. For this they need to see equity holdings as conferring rights of ownership, rather than just as part of an investment portfolio with returns to be maximised.⁹⁰ Institutional investors with a large number of firms in their portfolio may prefer to concentrate on firms within similar sectors of the economy, so that experience gained from learning about the *modus operandi* of one firm and its operating environment

⁸⁶ Dimsdale, 'Need to Restore Corporate Accountability', p. 20; Shleifer and Vishny, 'A Survey', pp. 753-754.

⁸⁷ John Pound, 'Beyond Takeovers: Politics Comes to Corporate Control', *Harvard Business Review*, March-April (1992), 83-93, pp. 83, 86; Robert Mangel and Habir Singh, 'Ownership Structure, Board Relationships and CEO Compensation in Large US Corporations', *Accounting and Business Research*, 23 (Special Issue) (1993), 339-350, p. 339.

⁸⁸ Hirschman, *Exit, Voice and Loyalty*, pp. 40-41.

⁸⁹ Nicholas Kochan and Michel Syrett, *New Directions in Corporate Governance*, Research Report 2137 (London: Business Information, 1991), p. 3; Dimsdale, 'Need to Restore Corporate Accountability', p. 30.

can be transferred in their monitoring of other firms in a similar position. This strategy may cause institutions to be insufficiently diversified and open to correlated risks, but since this arrangement persists in market-based systems and is mirrored by large shareholders in bank-based systems, it would appear that the expected costs are less than those of relinquishing control.⁹¹ It is also possible that free-riding will be incurred amongst other shareholders, but this should only be problematic where large investors have interests that contradict those of the firm, and that may result in long-term deterioration in the enterprise's performance in the absence of action by other shareholders.

As well as individual investors, voucher privatisation depended upon the participation of intermediaries acting corporately on behalf of dispersed shareholders.⁹² The Klaus government expected these to evolve and to perform corporate governance functions to facilitate the owner-driven restructuring it desired in privatised firms. IPFs as owners of newly privatised firms and board members through their shareholdings were supposed to have adequate incentives to monitor firms in their portfolio and oversee the management to ensure that the enterprise is being operated in a sustainable manner.⁹³ Supplementing this would be information they collected during the bidding phases over firms that together should allow them to make rational

⁹⁰ Short and Keasey, 'Institutional Shareholders and Corporate Governance', p. 25.

⁹¹ Sweder van Wijnbergen and Anton Marcinin, *Voucher Privatization, Corporate Control and the Cost of Capital: An Analysis of the Czech Privatization Programme*, CEPR Discussion Paper, 1215 (London: CEPR, 1995), p. 21; Shleifer and Vishny, 'A Survey', p. 758.

⁹² Jan Mladek and Iraj Hashi, 'Voucher Privatisation, Investment Funds and Corporate Governance in Czechoslovakia', *British Review of Economic Issues*, 15 (37) (1993), 67-95, p. 70. The degree to which this was formalised differs between countries. In Poland, these were to be created by the state whilst the Czech government expected them to emerge spontaneously. Raj M. Desai, 'Reformed Banks and Corporate Governance in the Czech Republic 1991-1996', *Post-Soviet Geography and Economics*, 37 (1996), 463-494, pp. 467-468; Dušan Tříska, *The Role of Investment Funds in the Czech Republic*, Working Paper, 23 (Ann Arbor: Davidson Institute, 1996, pp. 6, 7.

⁹³ Harold Demsetz, *Ownership, Control and the Firm: The Organisation of Economic Activity: I* (Oxford: Blackwell, 1990), p. 231.

investments for the benefit of the shareholders investing in the IPF. IPFs with sound financial backing can adopt a long-term outlook on investment and restructuring and implement extensive investment and restructuring strategies in conjunction with the incumbent management. This ability of some investors to hold a long-term perspective could result in undervalued enterprises being acquired by funds with the greatest ability and incentive to restructure them.⁹⁴ Funds planning to take an active role in restructuring would be expected to bid for large quantities of stock in a small number of enterprises to facilitate gaining board representation and actively undertake restructuring and corporate governance functions.

The reality in the Czech Republic has been that despite their continued presence, not all IPFs have long-term restructuring as their aim, so any changes in firms cannot be attributed with certainty to the actions of IPFs. IPFs motivated by immediate profit and attempting to maximise the immediate value of the firm and its share sales are unlikely to undertake deep restructuring, probably indicating a lack of funds or limited access to technology and new markets.⁹⁵ This scenario led to criticisms of IPF ownership in the firms studied here because respondents perceived that “these only wanted profits. They did not understand our production and were ruled by officials and not by managers” (Rozdat Systems 4, Technical Director), and similarly,

at the start of privatisation, ownership was by IPFs, the ownership of these was uncertain and they were only interested in profit, not investing in machinery (Odras KM 1, Managing Director).

⁹⁴ Brom and Orenstein, ‘Privatised Sector in the Czech Republic’, pp. 913-914.

⁹⁵ Coffee, ‘Institutional Investors in Transitional Economies’, pp. 155-156; Ingeborg Nemcová, ‘Lessons from Czech Privatisation’, in *Entrepreneurship and Economic Transition in Central Europe*, edited by Jean-Paul Larçon (Dordrecht: Kluwer/HEC School of Management, 1998), pp. 37-55, p. 47.

Another respondent saw this as a difficulty of these owners, commenting that

unfortunately Císař was under the influence of IPFs that sold shares to owners who appear to have the strategy of trying to suck money out of the company and put it elsewhere. They are not interested in the renovation of the company (Císař 3, Retired Analyst).

Particular problems arose in the Czech Republic because the personnel resources of IPFs prevented them from actively pursuing restructuring within firms. Even where IPFs have sufficient representation on company boards to fire the management, this is not always a credible threat. A limited supply of qualified personnel as potential replacements exists, especially following the 1992 Lustration Law that decreed former Communist Party officials or secret police members could not hold public office for 5 years, including management positions of firms where the state has a majority equity holding.⁹⁶

As well as being external actors with skills to help combat agency problems, IPFs were expected to place their staff onto the boards of newly privatised enterprises as shareholder representatives. In appointing directors to boards, the same restricted market for personnel is entered. Some IPFs have tried to overcome this by using their own staff⁹⁷ as in Císař where

⁹⁶ Ian Jeffries, *Socialist Economies and the Transition to the Market: A Guide* (London: Routledge, 1993), p. 387; Roderick Martin, *Transforming Management in Central and Eastern Europe* (Oxford: Oxford University Press, 1999), p. 13.

⁹⁷ Stijn Claessens and Simeon Djankov, 'Enterprise Performance and Management Turnover in the Czech Republic', *European Economic Review*, 43 (1999), 1115-1124, p. 1117.

IPFs bought individual vouchers and then became the owners and investor in companies. At the start, the management were the same as before 1989, but over time the IPFs wanted to put their people on the boards (Císař 1, Trade Union President).

Despite the apparent ineffectiveness of this form of shareholder participation because these new shareholders often lack expertise in key roles,⁹⁸ the replacement of managerial teams in enterprises by IPF owners has continued.⁹⁹ The reasons for this are unclear but it may simply be that in the absence of any alternative behaviour, this symbolises the IPFs trying to justify their ownership status.¹⁰⁰ In Brodchmel however this has led to a perception that the company is “owned from Prague by professionals who by law meet once a month” (Brodchmel 2, Project Manager), and so these are not seen as credible or effective owners, leaving the principal-agent problem unresolved.

IPFs may not monitor firms adequately because they do not have significant equity holdings in the companies they represent, and so do not benefit directly from an increased market value arising from proactive intervention.¹⁰¹ Substantial equity stakes cannot ensure that IPFs will become active owners, since the marginal costs of intervention can initially outweigh the marginal benefits quite substantially.¹⁰² Despite investment in IPFs reaching very high levels in both waves of voucher privatisation, establishing their role as significant owners in the newly privatised sector, IPFs can be in a contradictory situation with regards restructuring. They have

⁹⁸ Hans J. Blommestein, Rainer Geiger and Paul G. Hare, ‘Privatising Large Enterprises: Overview of the Issues and Case Studies’, in *Methods of Privatising Large Enterprises* (Paris: OECD/CCEET, 1993), 11-37, p. 20.

⁹⁹ Klacek and Flek, *Company Restructuring*, p. 6.

¹⁰⁰ Coffee, ‘Institutional Investors’, p. 153.

¹⁰¹ Coffee, ‘Institutional Investors’, pp. 112-113; Mládek, ‘Czech Companies’, pp. 45-46.

characteristics of both "active" owners as direct investors in firms, as well as being "passive" because of their obligation to maintain the market price of the shares and pay dividends.¹⁰³ Consequently those transferring vouchers to IPFs have often only converted their nominal co-ownership of firms to become passive owners in the funds.¹⁰⁴

Klaus originally foresaw IPFs as private intermediaries, aiding ownership and restructuring of enterprises because they "privatise the privatisation process" by reducing the potential for direct state activity in firms.¹⁰⁵ However, state-owned joint-stock companies were permitted as ICs, which accounts for the significant number of bank-owned funds.¹⁰⁶ Intended to bring benefits that included increased public confidence in the financial stability of IPFs,¹⁰⁷ and the ability to adapt their existing information infrastructure, in reality it has restricted monitoring and restructuring because IPFs owned by ICs that are sponsored by state banks represent state ownership in the private sector. This had the effect that

¹⁰² Mládek, 'Czech Companies', p. 153; Coffee, 'Institutional Investors', p. 157.

¹⁰³ Marie Bohatá, 'Some Implications of Voucher Privatization for Corporate Governance', *Prague Economic Papers*, 7 (1998), 59-65, p. 59; Pavel Mertlík, 'A Case Study: The Czech Privatization and Subsequent Structural Changes in Capital Ownership and Property Rights', *Economic Survey of Europe*, 2 (1998), 103-110, p. 104.

¹⁰⁴ Jiří Večerník, 'Capitalist Renewal: Privatization and Business', in *Ten Years of Building Capitalism: Czech Society After 1989*, edited by Jiří Večerník and Petr Matějů (Praha: Academia, 1999), pp. 70-93, p. 77.

¹⁰⁵ Cheryl W. Gray, *In Search of Owners: Lessons of Experience with Privatization and Corporate Governance in Transition Economies*, Policy Research Working Paper, 1595 (Washington: The World Bank, 1996), pp. 23, 25; Iraj Hashi and Alison Sinclair, 'Managerial Behaviour and Supply of Shares in the Czech Voucher Privatisation Programme', *Most-Most*, 6 (1996), 103-121, pp. 106-107.

¹⁰⁶ Jan Mladek, 'The Different Paths of Privatization in Czechoslovakia, 1990-?', in *Privatization in the Transition to a Market Economy. Studies in Preconditions and Policies in Eastern Europe*, edited by John S. Earle, Roman Frydman and Andrzej Rapaczynski (London: Pinter, in association with Central European University, 1993), pp. 121-146, p. 131.

¹⁰⁷ Roman Frydman, Kenneth Murphy and Andrzej Rapaczynski, *Capitalism With a Comrade's Face* (Budapest: Central European University Press, 1998), p. 31.

pseudo-owners came from areas where there was money e.g. banks. These owners did not know how to take care of property and therefore usually managed in a bad way. Usually banks owned the companies and would buy or own them through the IPFs. The main goal of the banks was to try and keep the activities operating to try and make money in the short run and to then sell the company (Císar 4, Services Director).

Institutional limitations to intermediaries acting as efficient governance agents in Czech firms are not exclusive to the IPFs, with such criticisms also levied at bank owners as in Brodchmel where

after privatisation financiers have owned the company and their main goal is to make profit and pay dividends. They made money and this should have been used to renew the machinery and buy new, but because the new owners are banks and invested in the company, they wanted to have this money back (Brodchmel 2, Project Manager).

In the Czech Republic the state also retains a significant ownership stake with the National Property Fund owning up to 40% of the book value of enterprises privatised by voucher.¹⁰⁸ Nevertheless, the direct influence of the government on enterprise managers is of secondary importance with the strong dependence of Czech companies on bank credits.¹⁰⁹

¹⁰⁸ Brom and Orenstein, 'Privatised Sector in the Czech Republic', pp. 894, 911.

¹⁰⁹ Bohatá, 'Some Implications', p. 60.

Although the governments in the Czech Republic have remained relatively passive in its dealings with the banks, their continued state ownership could become a greater problem to privatising firms if a future government were to adopt a more paternalistic economic policy towards the banks.¹¹⁰ Any state ownership, whether overt or hidden, is liable to affect restructuring decisions. Representatives on enterprise boards in firms with such state ownership could act against the signals from the market, to promote social and political objectives such as employment preservation,¹¹¹ raising doubts over the potential for state intervention in the future.¹¹² Market forces would be subordinated to soft budget constraints and managers would not longer face as strict market discipline as in private firms, giving them more opportunity to maximise their own interests, rather than those of the owners.

A further institutional limitation facing institutional investors in exercising corporate governance is that the composite ownership of individual enterprises was widely dispersed between IPFs and individual shareholders with privatisation.¹¹³ This was despite heavily concentrated ownership by institutional owners after the completion of voucher privatisation, with their holding over two-thirds of all shares in both rounds.¹¹⁴ To promote the dissemination of investment risk through IPFs having diversified portfolios, the initial legislation allowed ICs to own only 40% of shares in a company, providing the maximum limit of 20% by any IPF was not exceeded.¹¹⁵ The legal provision was later amended such that the 20% limit should apply to all

¹¹⁰ Frydman *et al*, *Capitalism With a Comrade's Face*, p. 33.

¹¹¹ Stijn Claessens, 'Corporate Governance and Equity Prices: Evidence from the Czech and Slovak Republics', *Journal of Finance*, 52 (1997), 1641-1658, pp. 1647, 1655-1656.

¹¹² Brom and Orenstein, 'Privatised Sector in the Czech Republic', p. 895.

¹¹³ Peter Kenway and Eva Klvačová, 'The Web of Cross-Ownership Among Czech Financial Intermediaries: An Assessment', *Europe-Asia Studies* 48 (1996), 797-809, p. 802.

¹¹⁴ Mladek and Hashi, 'Voucher Privatisation', p. 83.

IPFs founded by a single parent, but this has the effect of restricting the ability of institutional investors to exert influence over the incumbent management on behalf of their shareholders. Also, although designed to protect minority shareholders from being exploited by larger shareholders, the limits were not always adhered to.¹¹⁶ A “web of cross-ownership”¹¹⁷ of financial intermediaries involved in privatisation arose in the Czech Republic because many of the ICs founded or had significant equity or credit interests in more than one IPF.¹¹⁸

Principal-agent problems are not necessarily overcome in Czech firms after privatisation because of the absence of a “monitor of the monitors”¹¹⁹ and cross-ownership of IPFs. Conflicting relationships between firms and their creditors can result in IPFs having greater incentives to act in the interests of their founders rather than those of the firm’s shareholders. There can be a lack of accountability by large investors to shareholders in either their own funds or shareholders in firms they own.¹²⁰ Shareholders in IPFs exercise limited pressure on their funds because of their dispersed nature that encouraged them to invest in an IPF initially. By contrast, the founding company has a direct impact on the actions of its subsidiaries and directs them to act in the founder’s interest, which may cause IPF-affiliated directors to orient their activities towards maximising opportunities for this parent rather than

¹¹⁵ Coffee, ‘Institutional Investors’, p. 128; Roland Egerer, *Capital Markets, Financial Intermediaries, and Corporate Governance: An Empirical Assessment of the Top Ten Voucher Funds in the Czech Republic*, Policy Research Working Paper, 1555 (Washington: The World Bank, 1995), p. 3.

¹¹⁶ Egerer, *Capital Markets*, p. 8; John S. Earle, Scott G. Gehlbach, Zuzana Saková and Jiří Večerník, *Mass Privatization, Distributive Politics, and Popular Support for Reform in the Czech Republic*, Institute of Sociology Working Paper, 4 (Prague: Academy of Sciences of the Czech Republic, 1997), pp. 28-29.

¹¹⁷ Kenway and Klvačová, ‘Web of Cross-Ownership’, p. 797.

¹¹⁸ Masahiko Aoki and Hyung-Ki Kim, ‘Corporate Governance in Transition Economies’, *Finance and Development*, 32 (3) (1995), 20-22, p. 22; OECD, *Economic Survey: Czech Republic 1997-1998* (Paris: OECD, 1998), p. 65.

¹¹⁹ Gray, *In Search of Owners*, p. 24; Patrick Helson, *Privatisation in Eastern Europe*, ADU Occasional Paper, 14 (Wye: Department of Agricultural Economics, Wye College, 1993), p. 8.

¹²⁰ Shleifer and Vishny, ‘A Survey’, p. 758; Sternberg, *Corporate Governance*, pp. 60, 68.

endeavouring to maximise returns for shareholders.¹²¹ This is especially common if there is a dominant IPF to whose founding IC the enterprise has a conflicting relationship, such as a bank holding outstanding debts of the enterprise, or where bankruptcy is a possibility and the bank's role as a creditor may take precedence over optimal restructuring decisions.¹²² The emergence of financial institutions such as IPFs separates owners from managers, which may help overcome corporate governance problems within the enterprise and encourage restructuring. However, IPF fund managers are agents and not owners of the shares in their funds, so separating ownership from control still further and introducing another set of actors between the management and shareholders. This can exacerbate agency problems that corporate governance is meant to alleviate. If the enterprise management expects state assistance to be granted in the future, they may adopt behaviour including lobbying for continued protection or subsidies that is contrary to the fiscal propriety required to complement the IPFs efforts as owners to bring about restructuring. IPFs can also collude with the management, replicating the effects of insider ownership,¹²³ and annulling much of the effects of any corporate governance mechanisms.¹²⁴ Consequently voucher privatisation did not eradicate the "ties that bind" the state and enterprises but cross-ownership "re-arranged them" by introducing further

¹²¹ Mayhew and Seabright, 'Incentives and the Management of Enterprises', p. 111; Blair, *Ownership and Control*, pp. 47, 182.

¹²² Blair, *Ownership and Control*, p. 47; Stijn Claessens, Simeon Djankov and Gerhard Pohl, *Ownership and Corporate Governance: Evidence from the Czech Republic*, Policy Research Working Paper, 1737 (Washington: The World Bank, 1997), p. 6.

¹²³ Dimsdale, 'Need to Restore Corporate Accountability', p. 20; Philippe Aghion and Wendy Carlin, 'Restructuring Outcomes and the Evolution of Ownership Patterns in Central and Eastern Europe', in *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*, edited by Salvatore Zecchini (Dordrecht: Kluwer Academic/OECD, 1997), pp. 241-261, p. 242.

¹²⁴ Jonathan R. Macey, 'Institutional Investors and Corporate Restructuring: A Demand-Side Perspective in a Comparative View', in *Comparative Corporate Governance: The State of the Art and Emerging Research*, edited by Klaus J Hopt, Hideki Kanda, Mark J. Roe, Eddy Wymeersch and Stefan Prigge (Oxford: Oxford University Press, 1998), pp. 903-919, p. 918.

contradictions into claims over assets with shared ownership.¹²⁵ Ownership patterns emerging from voucher privatisation did not always represent those of functioning market economies, particularly with cross-ownership arising from the involvement of IPFs,¹²⁶ but also continued state ownership has often resulted in the emergence of only “quasi-private” firms.¹²⁷

4.3.3 Share Consolidation and Corporate Governance.

Alongside dispersed ownership, cross-ownership has allowed many IPFs to achieve controlling positions in firms where they do not have majority shareholdings.¹²⁸ To allow restructuring to occur there is a need for subsequent reconfigurations of ownership after share transfers with mass privatisation to re-allocate resources and bring sufficient incentives to change. This gives a crucial role to the newly emergent capital markets, as

[i]t is the dilemma of mass privatisation policies that they establish the promise of mass ownership, but ultimately depend upon capital markets to achieve the concentration of shares in the hands of strategic investors who can effect control.¹²⁹

¹²⁵ Lubomír Mlčoch, ‘Czech Privatization – Penalties for the Speed’, *Prague Economic Papers*, 6 (1997), 3-15, p. 10; Stark and Bruszt, *Postsocialist Pathways*, p. 162.

¹²⁶ Brom and Orenstein, ‘Privatised Sector in the Czech Republic’, p. 920; Aureliusz M. Pedziwol, ‘The Great Game of Privatization’, *Transition*, 3 (1) (1997), 36-40, p. 40.

¹²⁷ Alice H. Amsden, Jacek Kochanowicz and Lance Taylor, *The Market Meets its Match: Restructuring the Economies of Eastern Europe* (Cambridge, MA: Harvard University Press, 1994), p. 123; Mlčoch, ‘Czech Privatization’, p. 11.

¹²⁸ Mládek, ‘Czech Companies’, p. 163; Kenway and Klvačová, ‘Web of Cross-Ownership’, p. 802; OECD, *Czech Republic 1997-1998*, p. 53.

¹²⁹ Kogut and Spicer, *Institutional Technology*, p. 35.

Dispersal as institutionalised in the Czech model with the 20% limit on ownership can prevent effective corporate governance being exercised over firms where dispersed individual owners comprise the majority shareholders, since this makes it much harder to attain a consensus. If these IPFs are to act as efficient intermediaries they need the opportunity to concentrate their holdings,¹³⁰ especially in key enterprises they own so that they have extra leverage and greater incentives to become active monitors. The incumbents in particular do not always regard IPFs as the final owners, although this problem is being rectified with much higher concentrations of ownership resulting after share trading in the "third wave". This is the period since the completion of bidding and share allocations where investment funds have been engaged in portfolio re-adjustments to consolidate their portfolios and efficiently restructure their holdings according to their differing investment interests and become major shareholders in specific firms.¹³¹

Since restructuring is required at both the micro level in individual enterprises and at a macro level within the economy, a "fourth wave" of voucher trading with credible policies of bankruptcy and liquidation may be inevitable in the Czech Republic.¹³² One respondent spoke of the necessity of such rationalisation, desiring that

¹³⁰ Kenway and Klvačová, 'Web of Cross-Ownership', pp. 802-803, 808.

¹³¹ Eric R. Hake, 'Third Wave of Privatization: A Search for True Owners?', in *Financial Market Restructuring in Selected Central European Countries*, edited by Karen S. Vorst and Willadee Wehmeyer (Aldershot: Ashgate, 1998), pp. 151-181, pp. 155, 170; Michal Mejstřík, 'The Restructuring After Privatization in the Czech Republic', *Prague Economic Papers*, 8 (1999), 233-260, pp. 251-252.

¹³² Xavier Richet, 'Transition Towards the Market in Eastern Europe: Privatisation, Industrial Restructuring and Entrepreneurship', *Communist Economies and Economic Transformation*, 5 (1993), 229-243, p. 236; Petr Chvojka, 'Financial Context of Central and East European Countries Process of Privatisation and Restructuring (Czech Republic, Poland, Hungary)', *Prague Economic Papers*, 7 (1998), 140-164, pp. 142-143.

those who own shares should be evaluated and the rest of the shares that do not belong to anyone should be sold at a lower price so that something is done and these are not wasted (Brodchmel 4, Quality Manager).

Such rationalisation of shareholdings should introduce new owners to actively restructure firms and increase the overall economic efficiency of the economy. Most important though is that the restructuring process should ensure the establishment of a new framework for economically oriented production.¹³³ The precursor to this is effective corporate governance because this will allow new owners to emerge and control asset use within enterprises, but as the case study firms show in the next section, an adequate corporate governance system to support new owners has not emerged as a consequence of voucher privatisation.

4.4 CORPORATE GOVERNANCE AFTER VOUCHER PRIVATISATION.

The two preceding sections have described the archetypal models and mechanisms of corporate governance currently used in developed economies. This has shown that whilst some features of both are paralleled by post-privatisation corporate governance in the Czech Republic, there are important differences in its outworking here because of institutional influences. This idea is extended in this section where the experiences of the case study firms from a perspective of embedded institutionalism illustrate how corporate governance is being developed in these firms after voucher privatisation.

¹³³ George B. Assaf, 'Enterprise Restructuring in Central and Eastern Europe and the Former Soviet Union: The Role of Technical Assistance', in *Privatization, Enterprise Development and Economic*

Following voucher privatisation, new owners are often institutionally constrained from restructuring their firms because of limitations inherent within enterprises and the surrounding institutional environment. This indicates that there is an insufficiently developed corporate governance framework to facilitate the desired restructuring in voucher privatised firms in the Czech Republic.

Voucher privatisation only represents a “restructuring of ownership”,¹³⁴ but for enterprise restructuring to occur, appropriate incentives for owners or another constituency within the firm to support improvements in efficiency and owners’ interests are required.¹³⁵ Even when a significant or majority shareholder can be identified, they may not have the ability to instigate change,¹³⁶ so voucher privatisation risks one form of inefficient ownership being superseded by another. Respondents criticised this as a failing of voucher privatisation, seeing that although “it was quick, it did not solve the problem of owners” (Odráz KM 2, Marketing Manager) and

a concrete owner was expected to come and be interested in development of the firm, but this did not happen with voucher privatisation (Rozdat Systems 4, Technical Director).

The extent to which owners are involved in their firms is an important determinant of the restructuring that occurs. According to one respondent

Reforms: Experiences of Developing and Transitional Economies, edited by Paul Cook, Colin Kirkpatrick and Frederick Nixon (Cheltenham: Elgar, 1998), pp. 129-149, p. 138.

¹³⁴ Chvojka, ‘Financing Enterprise Restructuring’, p. 81.

¹³⁵ Ken G. Smith, Terence R. Mitchell and Charles E. Summer, ‘Top Level Management Priorities in Different Stages of the Organizational Life Cycle’, *Academy of Management Journal*, 28 (1985) 799-820, p. 801.

the contemporary owners do have an interest in the firm and they are looking at strengthening this, but it is likely that they would be a stronger owner if Přesnost KM produced in a different field of production that was closer to the interests of Obchodní Cesta (Přesnost KM 1, Financial Planning Manager).

In Rozdat Systems the new owners were regarded less favourably as it was perceived that

the priority of owners should be manufacturing, and they must have an interest in production, in selling and trading, and getting money to re-invest it, but the current owners here only look at the situation in terms of profit. They want money very quickly, but this can be slower in practice than the owners, workers and customers would be satisfied with (Rozdat Systems 2, Production Manager).

Another respondent argued that this occurred since

the owners do not understand the firm, probably because they only see it as a commercial subject in terms of results from production and trade. They don't know many of the problems in the firm, or if they do they found out too late and now many of them cannot be solved as they are too big (Rozdat Systems 3, Maintenance Department supervisor).

¹³⁶ Aureliusz M. Pedziwol, 'The Great Game of Privatization', *Transition*, 3 (1) (1997), 36-40, p. 38.

The benefits of privatisation are most likely to be seen if this introduces owners with new sources of capital as well as entrepreneurial expertise and access to markets,¹³⁷ but in the Czech Republic new domestic owners have only very limited capital and business acumen to bring to privatised firms.¹³⁸ Limited liquidity combined with a reliance on bank credit may deter post-privatisation restructuring in the Czech Republic¹³⁹ for although "more restructuring would be possible with other methods of finance, it is very difficult to get this" (Rozdat Systems 5, Financial Director). Respondents specifically saw this as a negative consequence of voucher privatisation compared to other privatisation methods because "those buying coupons in the initial stages did not have enough money to restructure the company" (Císař 1, Trade Union President), since

voucher privatisation has been carried out in such a way that each company has been bought and financed by credit. People buying these companies inherited their debts and with their limited financial resources, have not been able to pay them off in such a short period of time (Přesnost KM 1, Financial Planning Manager).

This institutional environment demanded a privatisation approach that would inject new capital and dynamism into the economy because market forces are not sufficient under these conditions. Non-monetary techniques of property transfers were used through voucher privatisation because of institutional constraints in the economy.

¹³⁷ Cheryl W. Gray, 'In Search of Owners: Privatization and Corporate Governance in Transition Economies', *The World Bank Research Observer*, 11 (2) (1996), pp. 179-197, pp. 180.

¹³⁸ Dieter Börs, 'Privatization in Europe: A Comparison of Approaches', *Oxford Review of Economic Policy*, 9 (1993), 95-111, p. 106.

¹³⁹ Chvojka, 'Financial Context', pp. 145, 149; Debora Revoltella, 'Financing Firms in East European Countries: An Asymmetric Information and Agency Costs Approach', in *Corporate Governance in*

The primary theoretical problem is the lack of revenue generated by this method, both for the new enterprises and the state,¹⁴⁰ a concern that can also be levied at restitution. However, outweighing the financial concern for the government was that non-monetary distributions helps avoid refuelling inflationary pressure in the economy¹⁴¹ that would have been inimical to the other aims of the reforms. Also Czechoslovakia had a virtually balanced budget in 1989, so financial stability was a relatively low priority for the government at the time.¹⁴²

More serious with regards meeting the long run aims of the government is that enterprises do not obtain new capital inflows from voucher privatisation, and many already lack resources for restructuring.¹⁴³ In Císař, one of the directors claimed

there are no problems in the quality of production and its completion on time but there are problems in finance. The company has orders worth Kč 100 to 120 million but the company cannot finance these itself. To overcome this, the ideal state would be long run co-operation with banks to support these big orders but at the moment the company has to get money from other companies at very high interest rates, which is not a good situation. The consequences will be seen in the profit of the company and of course this will influence the costs of production and there will be no additions to financial reserves, but this has to be

Central and Eastern Europe: Transition Management is a Tough Job, edited by Debora Revoltella, Peter R. Haiss and Gerhard Fink (Amsterdam: SUERF, 1998), pp. 9-50, pp. 18, 45.

¹⁴⁰ Aureliusz M. Pedziwol, 'Great Game', *Transition*, 3 (1) (1997), 36-40, p. 36; Frydman *et al*, *Capitalism With a Comrade's Face*, p. 26.

¹⁴¹ Martin Myant, 'Problems of Transition in Eastern Europe - Should We Seek Alternatives?', *British Review of Economic Issues*, 15 (37) (1993), 9-32, p. 28.

¹⁴² Frydman *et al*, *Capitalism With a Comrade's Face*, p. 26.

¹⁴³ Josef Kotrba, 'Privatisation Processes in the Czech Republic: Players and Winners', in *The Czech Republic and Economic Transition in Eastern Europe*, edited by Jan Svenjar (San Diego: Academic Press, 1995), pp. 159-198, p. 198; Frydman *et al*, *Capitalism With a Comrade's Face*, p. 15.

done otherwise we would lose the customers and we cannot afford this (Císař 4, Services Director).

Another respondent described how this was a difficulty arising from voucher privatisation, seeing it as

very unfortunate for the firm, and not just this firm but for most of the Czech Republic. A general expectation was that the sale of firms should bring improvements in its situation and all the environments such as financial and markets that are linked to it. This did not happen in Přesnost KM as privatisation occurred with voucher privatisation and this could not bring new capital (Přesnost KM 1, Financial Planning Manager).

Although voucher privatisation was structured to maximise domestic ownership, the costs of not encouraging strategic investors able to undertake restructuring in the economy outweigh these advantages when restructuring in the longer-term is considered. One director seeing this as a potential solution to permit firms to restructure commented that

personally I prefer the German method of privatisation. I like the principle of selling companies to individuals with finances. There, medium-sized companies were offered in auctions and were bought by individuals and so even the unprofitable firms were sold to individuals as well who then decided if it was worth to try and run, or to close the business (Císař 4, Services Director).

Not only can private investors as owners provide funds for restructuring, but they are subject to hard budget constraints, so efficiency is essential in their firms to ensure they are competitive. Primarily it is foreign investors that have knowledge of alternative methods of organising production and resources to deploy in introducing creative restructuring solutions.¹⁴⁴ As the effectiveness of a given type of ownership is defined by access to resources rather than differing priorities between outside and domestic owners,¹⁴⁵ the appropriateness of the Klaus government in discouraging foreign investors from involvement in privatisation on ideological grounds is dubious.¹⁴⁶ In the short run, a number of Czech firms have been able to begin restructuring with little or no foreign assistance, and restructuring in any privatised enterprise should not be delayed in the absence of such assistance that may not even be forthcoming in the future.¹⁴⁷ Nonetheless, further difficulties could potentially be generated if this leads to an absence of new resources for strategic change, and by implication a lack of incentives to drive active changes in behaviour that would complement the move towards more market-oriented behaviour. This has already created real difficulties for one case study firm in its restructuring because

there is tough competition and we would like some help from outside, but
foreign companies fear the competition, and therefore there is no way we can

¹⁴⁴ Martin Myant, 'Transition in the Czech Republic', *Proceedings of the Scottish Society for Russian and East European Studies* (Glasgow: IREES, 1997), pp. 5-14, p. 9.

¹⁴⁵ Aghion and Carlin, 'Restructuring Outcomes', p. 245; Philippe Aghion and Olivier J. Blanchard, 'On Privatization Methods in Eastern Europe and their Implications', *Economics of Transition*, 6 (1998), 87-99, p. 88.

¹⁴⁶ Cyril C. Ling, 'The Development of the Automobile Industry in Eastern Europe', in *Firm Behavior in Emerging Market Economies: Cases from the Private and Public Sectors in Central and Eastern Europe*, edited by Daniel S. Fogel (Aldershot: Avebury, 1995), pp. 23-52, p. 35; Myant, 'Transition in the Czech Republic', p. 9.

¹⁴⁷ Robert E. Anderson, Stijn Claessens, Simeon Djankov and Gerhard Pohl, 'Privatization Effects in Central and Eastern Europe', *Moct-Most*, 7 (1997), 137-162, p. 139; Karen L. Newman and Stanley D. Nollen, *Managing Radical Organizational Change* (Thousand Oaks: Sage, 1998), p. 134.

learn about managing from foreign companies, and therefore we cannot reach their effectiveness (Brodchmel 4, Quality Manager).

A result of weak corporate governance can be that owners and their representatives are not actively involved in decision-making on restructuring issues, and if other shareholders are unable to offer a co-ordinated response, then the management can exercise *de facto* control freed from shareholder discipline.¹⁴⁸ As voucher privatisation institutionalises shareholder dispersal, this is an important consideration for Czech firms. This situation has occurred in Drazitest, where the “management, as the largest shareholder, makes decisions in their own interests” (Drazitest 2, Production Director). It is seen as beneficial here since the IPF has only minority ownership and

the IPF tried to have an influence but a 17% holding is not much, not because they are not interested in leadership or being involved, but because it is satisfied with the way the company operates and do not see any reason to be further involved (Drazitest 7, Personnel Manager).

Overall, the effect has been that

the top management shareholders are really involved. Here the owners understand the firm’s problems and anticipate them as they work here (Drazitest 3, Supplies Manager).

¹⁴⁸ Rajeswararas Chaganti and Fanborz Damanpour, ‘Institutional Ownership, Capital Structure and Firm Performance’, *Strategic Management Journal*, 12 (1991), 479-491, p. 480; Paul J. J. Welfens, *Market-Oriented Systemic Transformation in Eastern Europe: Problems, Theoretical Issues and Policy Outcomes* (Berlin: Springer-Verlag, 1992), p. 125.

In another firm a respondent perceived potentially positive as well as negative implications arose from the managerial control issue such that

managerial ownership can bring benefits as these have a greater interest in the firm and are more directly acquainted with its problems. However, this can also have some negative effects too and there are many examples of this in the Czech Republic where managerial ownership has resulted in workers becoming poor and the management getting rich as some managers are only interested in getting money and really do not care about the company and its business activities. They can do this as shareholders cannot really influence what happens in the company (Presnost KM 1, Financial Planning Manager).

Individual enterprises in the Czech Republic have to solve their own governance problems directly between shareholders, owners, and managers within each individual firm. The evolving institutional environment does not appear to predispose the Czech Republic towards any given corporate governance approach. Following voucher privatisation, corporate governance needs to function effectively in the absence of the basic institutions of capitalism, whilst as the previous quote demonstrates, there is a continuing expectation by workers that managers should act in the interests of the firm and its workforce, rather than to primarily satisfy profit motives. A direct transplant of Anglo-American, German or Japanese corporate governance systems is not appropriate because of differences and in the form of institutions and their complementary linkages in the Czech Republic.¹⁴⁹ A hybrid between the bank-based

¹⁴⁹ Andrei Kuznetsov and Olga Kuznetsova, *Corporate Governance in a Transitional Economy: Has Everything Been Done to Make the Concept Work?*, International Workshop on Transition and Enterprise Restructuring in Eastern Europe, 20-22 August 1998 (Copenhagen: CEES, Copenhagen

systems of continental Europe and the market-centred Anglo-American instead seems to be emerging. As neither bank nor market-based approaches offer an unambiguously superior corporate governance solution,¹⁵⁰ this trend towards “the simultaneous existence of bank financing and capital market financing”¹⁵¹ can be regarded positively in the transformation economies.

It also reflects a global development towards convergence in corporate governance models, which can produce better outcomes than using any single approach.¹⁵² That development is a response to organisational structures emerging through privatisation, as well as evolutions in formal and informal institutions.¹⁵³ The extent of restructuring that then occurs will be an adaptation to the external environment, in particular the legislative environment, the respective position of institutional investors, and pressures exerted by the market for corporate control.¹⁵⁴ Complex corporate governance systems only need to be designed when there are sufficiently complex contractual arrangements that need to be monitored in this way.¹⁵⁵ Whilst corporate governance is likely to extend and diversify over time as the transformation progresses in the Czech Republic,¹⁵⁶ brief consideration is made below of how the

Business School, 1998). 25 September 2000.

<<http://www.econ.cbs.dk/institutes/cees/workshop/Kuznetsov.html>>, p. 3.

¹⁵⁰ Nikolaos T. Milonas, *Mass Privatization Methods and their Effects on Capital Market Institutions, Agency Relationships and Managerial Monitoring*, Working Paper, 50 (Leuven: LICOS Centre for Transition Economics, 1995), p. 17.

¹⁵¹ Fakin, *Financial Institutions*, p. 22.

¹⁵² Kenneth J. Rediker and Anju Seth, ‘Boards of Directors and Substitution Effects of Alternative Corporate Governance Mechanisms’, *Strategic Management Journal*, 16 (1995), 85-99, p. 87.

¹⁵³ Klaus Meyer, *Direct Investment in Economies in Transition*, New Horizons in International Business (Cheltenham: Elgar, 1998), p. 20.

¹⁵⁴ William Q. Judge Jr. and Carl P. Zeithaml, ‘Institutional and Strategic Choice Perspectives on Board Involvement in the Strategic Decision Process’, *Academy of Management Journal*, 35 (1992), 766-794, pp. 767-768; Richard A. Johnson, Robert E. Hoskisson and Michael A. Hitt, ‘Board of Director Involvement in Restructuring: The Effects of Board versus Managerial Controls and Characteristics’, *Strategic Management Journal*, 14 (Summer Special Issue) (1993), 33-50, pp. 33-34, 36-39.

¹⁵⁵ Prevezer and Ricketts, ‘Corporate Governance’, p. 241.

¹⁵⁶ Stilpon Nestor and John Thompson, *Corporate Governance Patterns in OECD Economies: Is Convergence Under Way?*, OECD/Korean Development Institute Conference on Corporate

corporate governance system emerging in the Czech Republic should be understood, and whether provides sufficient institutional impetus for sustainable restructuring to occur within Czech enterprises after voucher privatisation.

4.5 CONVERGENCE OR A NEW MODEL?

Convergence in corporate governance does not imply the emergence of identical models, as these are a response to specific operating conditions, and historical influences within firms and economic systems. Empirical evidence is the only way to determine how the interplay of forces of governance are resolved for any particular enterprise, since market structures and other operating conditions, as well as the formal legal framework, determine the optimal form of corporate governance approaches,¹⁵⁷ and these can conflict. Governance tends to be less impersonal where there is more “noise” in the economic environment, because there are greater costs but also larger gains here for principals maintaining strict control over dispersed agents,¹⁵⁸ so investors with large shareholdings and institutions in the Czech Republic should have strong incentives to undertake governance. However, increasing competitiveness in financial markets as has occurred with voucher privatisation erodes the relationship between a firm and a few core financial institutions. The financial needs of firms diversify over time with restructuring but financial institutions concentrate increasingly on specific niches in the market, which requires a firm to establish a greater number of relationships. Commitment between firms and

Governance in Asia: A Comparative Perspective, Seoul, 3-5 March 1999. 18 May 1999.

<<http://www.oecd.org/daf/peru/governance/in-asia.nestor.pdf>>, p. 18.

¹⁵⁷ Frank H. Easterbrook, ‘International Corporate Differences: Markets or Law?’, *Journal of Applied Corporate Finance*, 9 (4) (1997), 23-29, p. 29.

financial institutions then diminishes because the potential returns to risk taking are low.¹⁵⁹ Shareholders will only actively undertake governance and restructuring if the gains from this exceed their private benefit from realigning their portfolios. Consequently, the institutional structure of ancillary markets helps determine the effectiveness of corporate governance under such conditions.

A more appropriate foundation for understanding the mechanisms of corporate governance emerging in the Czech Republic, and in transformational economies in general, when assessing the development of corporate governance from an institutional perspective, could be one of stakeholder interests rather than the traditional view of dominant shareholders having residual rights claims.¹⁶⁰ This alternative strand of corporate governance theory in the literature considers a larger spectrum of competing interests than just shareholders as in traditional models. The impact of decisions of a wide range of agents, extending from the employees and managerial team through to customers, suppliers and local communities, and the influence they can exert over the firm are accounted for in stakeholder theories.¹⁶¹ Stakeholder group membership does not have to be mutually exclusive or continuous for any given individual, rather being contingent on circumstances. These interests can often conflict with each other over time,¹⁶² yet benefits can arise from their interaction and the realisation of outcomes that are sensitive to the array of concerns

¹⁵⁸ Harold Demsetz and Kenneth Lehn, 'The Structure of Corporate Ownership: Causes and Consequences', *Journal of Political Economy*, 93 (1985), 1155-1177, p. 1159.

¹⁵⁹ Meyer, 'Corporate Governance and Performance', p. 21.

¹⁶⁰ Meyer, 'Corporate Governance and Performance', p. 17.

¹⁶¹ John Monks, 'Stakeholding: The Way Ahead', in *Competitiveness and Corporate Governance*, edited by Andrea Westall (London: IPPR, 1996), pp. 54-61, p. 56; David Wheeler and Maria Sillanpää, *The Stakeholder Corporation: A Blueprint for Maximising Stakeholder Value* (London: Pitman, 1997), p. x.

¹⁶² Gerry Johnson and Kevan Scholes, *Exploring Corporate Strategy*, 3rd Edition (Hemel Hempstead: Prentice Hall, 1993), pp. 171-172.

these represent.¹⁶³ Companies in transformational economies typically need to resolve many competing interests and claims on their firms arising from their historical development, as well as the new conditions offered by transformation. Often the incumbent management and other small groups gained levels of control disproportionate to their shareholdings through voucher privatisation because of the highly fragmented ownership that emerged. Stakeholder interests that justify these groups promoting their own self-interest could help explain the popularity of mass privatisation schemes amongst the incumbent management,¹⁶⁴ even if this is not recognised formally by participants.

Stakeholder theories can be criticised because they limit direct accountability to investors, and can reduce the total wealth generating capacity of the economy by focussing on non-economic gains.¹⁶⁵ This argument that such policies are necessarily economically detrimental is spurious, for any deviation away from profit-maximising behaviour needs to be assessed within the context of satisfying other objectives. Ensuring that the enterprise is profitable is important, but if stakeholder interests are to be considered, the ethical and social implications of the firms' actions and attempts to increase non-commercial, value-adding activities becomes rational.¹⁶⁶ Supporting stakeholders has advanced as a positive trend in developed market economies where there is an adequate legal and regulatory provision to control and direct this. In the Czech Republic however, this could give rise to some difficulties by merely allowing the management to satisfy the demands of more powerful external actors, perhaps in

¹⁶³ Monks, 'Stakeholding', p. 58; John Parkinson, 'Reforming Governance to Improve Discipline and Support Co-Operative Relationships', in *Competitiveness and Corporate Governance*, edited by Andrea Westall (London: IPPR, 1996), p. 69; Wheeler and Sillanpää, *Stakeholder Corporation*, p. 144.

¹⁶⁴ Scott Thomas, 'The Politics and Economics of Privatization in Central and Eastern Europe', *Columbia Journal of World Business*, 28 (1) (1993), 166-178. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

the expectation of increasing their own pecuniary benefits at the expense of shareholders and creditors, and resultant negative performance in the enterprise.¹⁶⁷

Nonetheless, representing a reworking of the traditional corporate governance dichotomy, stakeholder theories of governance potentially offer an alternative approach that may be applicable to the Czech Republic, primarily because of the existence of multiple groups with interests to be reconciled. Should it be adopted and represent a form of corporate governance that is most suitable to the conditions here, this could offer the transforming economies the opportunity to lead rather than lag behind their economic competitors, overcoming possibly the most debilitating legacy of the socialist era. However, without a precise understanding of the aims towards which enterprises are oriented, contradictory development in the institutional framework that would appear to support an Anglo-Saxon governance model, and commercial legislation that is predominately inspired by a German system, the corporate governance mechanisms that will emerge in the Czech Republic remain unclear.¹⁶⁸ Juxtaposing fundamentally contradictory corporate governance systems is unlikely to bring an optimal outcome¹⁶⁹ but instead give scope to the strongest interests to manipulate governance to favour their own interests, which is unlikely to be shareholders. Although this does occur in the seemingly altruistic German and Japanese corporate governance systems that favour long-term enterprise growth and

¹⁶⁵ Sternberg, *Corporate Governance*, pp. 106-107.

¹⁶⁶ Parkinson, 'Reforming Governance', p. 69; Wheeler and Sillanpää, *Stakeholder Corporation*, p. ix.

¹⁶⁷ Eugene F. Fama and Michael C. Jensen, 'Separation of Ownership and Control', *Journal of Law and Economics*, 26 (1983), 301-325, p. 304; Demsetz, *Ownership*, pp. 378-379.

¹⁶⁸ Hayri and McDermott, p. 1; David L. Bartlett, 'Has the East Really Become the South? Ownership Structure and Economic Policy in Eastern Europe', *Politics and Society*, 25 (1997), 202-231.

Academic Search Elite. EBSCO Publishing. 8 May 1999.

<<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

¹⁶⁹ Stephan Herten and Jens Hölscher, "Anglo-Saxon" or "Rhenish" Financial Markets for Central-East Europe?', in *Financial Turbulence and Capital Markets in Transition*, edited by Jens Hölscher (Basingstoke: Macmillan, 2000), pp. 13-24, p. 14.

wealth-creation, these models do not endeavour to uphold private property rights.¹⁷⁰

Introducing this model would be contrary to the aims of the general transformation since restoring private property was fundamental to re-establishing individual liberties in the Czech Republic, as well as helping to create a culture of popular capitalism. An eclectic approach to corporate governance is thus required to understand the governance mechanisms that are developing and guiding restructuring in firms after voucher privatisation.

4.6 CONCLUSION.

Moving from central planning, where there is no corporate governance as understood in developed market economies, to a system embracing this cannot occur immediately. Appropriate control mechanisms, whether through creditors skilled in restructuring firms within a bank-oriented system, or financial institutions and active shareholders to undertake market-based control as in the Anglo-American model, take time to emerge and develop.¹⁷¹ Despite the early involvement of the banks in enterprise financing, through voucher privatisation Klaus claimed a commitment to private financing, removing subsidies and soft budget constraints and the restructuring of enterprises by new owners, with the intention of creating "a market economy without complicating and obfuscating adjective added to the word market".¹⁷² The sale and distribution of vouchers with mass privatisation was to be a catalyst to active trading of equities, incorporating a desire to create an emergent stock market to facilitate active trading of shares as in the Anglo-American model, with price

¹⁷⁰ Sternberg, *Corporate Governance*, p. 92.

¹⁷¹ Berglöf, 'Capital Structure', pp. 256-257; Fakin, *Financial Institutions*, p. 22.

movements offering publicly available information on the absolute and relative performance of firms and disciplining managers. Financial intermediaries were always to be involved in voucher privatisation, although the architects of the programme did not foresee them as being involved in active restructuring, but rather as tools of collective investment with diversified portfolios. Financial intermediaries were legislated for in voucher privatisation to have an active monitoring and control agenda for long-term enterprise restructuring, but financial markets have remained thin,¹⁷³ which has hindered the development of corporate governance because of inconsistencies in the supporting institutional environment.

Understanding the evolution of corporate governance after voucher privatisation in the Czech Republic depends strongly on the institutional conditions in existence that prevent either of the main paradigms currently recognised from being appropriately adapted and implemented in Czech firms. The actual path of restructuring depends upon incentives facing owners and managers generated by the institutional environment for those actors in relationship with the firm, with informal institutions primarily dictating the pace of change. Discrepancies between the legislative provisions after voucher privatisation for exercising governance and the institutional realities in the Czech Republic have led to privatised firms experiencing difficulties with restructuring. In the Czech Republic, actors traditionally involved in corporate governance in developed market economies are lacking or restricted in their ability to undertake necessary and appropriate restructuring, especially after voucher

¹⁷² Klaus, *A Road to Market Economy: Selected Articles, Speeches and Lectures Held Abroad* (Praha: TOP Agency, 1991), p. 12.

¹⁷³ Desai, 'Reformed Banks', p. 464.

privatisation.¹⁷⁴ Even where new owners have emerged, they rarely have the ability or incentive to restructure their firms. Principal-agent problems are not fully resolved because of weakly specified and inconsistently operating corporate governance mechanisms, so rather than owners, other groups achieve *de facto* control over privatised enterprises, becoming those who will direct restructuring. This is particularly true for the management, who previously lacked credible discipline from the state as the owner under central planning, and who endeavour to avoid such control from being introduced, even after privatisation. Although a rational response to these circumstances, restructuring after voucher privatisation has not been supported by the corporate governance arrangements existing in the Czech Republic. Dispersed ownership from privatisation has a greater potential for future instability in corporate governance than with concentrated ownership from a clearly defined owner,¹⁷⁵ which has been a dilemma of voucher privatisation that has promoted managerial control to take precedence over ownership. The next chapter therefore addresses the role of managers with either *de facto* or *de jure* control rights on influencing restructuring within privatised enterprises.

¹⁷⁴ Mehmet Özkaya and Kosein Askari, 'Management of Thirty Privatized Companies: Its Importance and How Little We Know', *World Development*, 27 (1999), 1097-1114, p. 1105.

¹⁷⁵ Thomadakis, *Long-Term Investment*, p. 12.

CHAPTER FIVE

MANAGERS AND RESTRUCTURING

Neo-classical economic theory predicts that privatisation will produce new owners with incentives to restructure their firms, which was Klaus' intended outcome for voucher privatisation. However, this has not been realised in the Czech Republic where, in reality, owners are institutionally restricted in their ability to undertake restructuring. These institutionalised difficulties arise from the design of the voucher privatisation programme as well as the wider social, political, and economic environment within which firms operate, that negate the direct application of neo-classical economics to understanding privatisation and restructuring outcomes in the Czech Republic. As the previous chapter has shown, corporate governance mechanisms within firms have been weakly defined during the transformation. Institutional influences in transformational economies mean that those with control over enterprises are not necessarily those with formal ownership rights, invalidating the simple principal-agent prescription of neo-classical economic theory in such instances. To determine what restructuring will occur and who directs this, it is therefore important to consider the incentive structures of all agents involved in the firm.

The chapter argues that institutional influences exist for Czech firms, which are sufficient to exert influence over the choices and outcomes of managerial restructuring strategies after privatisation. Managers are important agents of change, and privatisation opens new opportunities as well as providing a credible impetus for them to change their behaviour. However, their choices and the outworking of these

in enterprises are impacted by institutional influences, so that actual restructuring outcomes in firms cannot be predicted *a priori*. The central argument of the chapter is that with weak corporate governance, principal-agent problems are not effectively overcome by voucher privatisation. As a result, managers retain the *de facto* control over enterprises gained from their privileged position attained in state-owned enterprises as unconstrained agents. Whilst this limitation arises from the way voucher privatisation was designed, the behaviour of managers in the restructuring of privatised enterprises is influenced by, and cannot be understood outwith the institutional environment because of path-dependency and embeddedness of the managerial function and the firm.

The existence of institutional influences does not preclude adequate and necessary restructuring from occurring after voucher privatisation. Nevertheless, there are factors endogenous and exogenous to the management function that impact on the overall changes they can and will undertake, and how beneficial these will be for restructuring. The measures the managers undertake and the effects of these are discussed in this chapter to ascertain whether voucher privatisation in the Czech Republic encourages managers to undertake restructuring. It is argued that the strategies of post-communist managers in restructuring their enterprises are a function of legacies of the centrally planned economy and behaviour this engendered; the expectations for change within firms, the way the firm is structured and extricates itself from the former economic system, as well as the interests of managers themselves to maintain and preserve their position.

Using data from the case study firms, this chapter considers the post-privatisation role of managers in the Czech Republic. In each section, the impressions of respondents are presented to assess the restructuring measures that managers introduce, given the context within which these occurred. Firstly, the expectations of managers and employees over the changing managerial role from privatisation and transformation are considered. This is compared to the historical function of managers under central planning, and legacies from this that can continue within privatised firms are then discussed. This contextualisation of the managerial function and behavioural patterns seen now is a precursor to the consideration of actual changes implemented by managers in privatised firms in the following sections. “Soft” changes represented by strategic planning, human resource management, adaptations in communication, and production changes are discussed alongside “hard” measures arising from alterations to the structural configuration of enterprises. Corresponding with the responses from the interviews, these embody the primary functions of contemporary managers and so represent the extent of managerial influence on overall restructuring. The chapter therefore demonstrates the institutional influences facing managers to undertake restructuring changes, and the extent to which they induce or prevent change.

5.1 CHANGING ROLE OF MANAGEMENT.

The tasks of the managerial function, and the status afforded it under central planning as little more than an administrative role, bears little resemblance to its proactive and distinct function as understood for enterprises in developed market economies.¹

¹ Michael Patrick Allen, Sharon K. Panian and Roy E. Lotz, ‘Managerial Succession and Organizational Performance’, *Administrative Science Quarterly*, 24 (1979), 167-180, p. 167.

Much of the managerial task under central planning was concerned with issues that arose aside from firm-specific production issues² such as meeting the demands of Party interests and acquiring resources to ensure plan fulfilment, with the effect that “the positions of managers were more generalised as the state-owned enterprise was led centrally by the state with set goals” (Císař 1, Trade Union President). Also, most former managers did not have experience of managing firms within different industries, and organisational homogeneity in the centrally planned economy discouraged a wide dissemination of skills and knowledge of alternative management techniques,³ especially those that would be useful under the new market conditions.⁴ In the post-communist transformation there is therefore a need not only for former state-owned enterprises to adapt to new opportunities afforded by liberalisation, but also for a redefinition of the role and institution of management if managers are to be able to implement appropriate restructuring measures.⁵

5.1.1 Post-Privatisation Expectations For Managers.

A significant institutional constraint preventing managers from altering their behaviour is that after privatisation managers risk losing their personal, as well as

² Sandor Nagy, ‘Historical Background of Management Development in Central and Eastern Europe’, *Review of Business*, 13 (4) (1992), 10-12. Academic Search Elite. EBSCO Publishing. 24 April 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

³ R. Whitley, J. Henderson, L. Czaban and G. Lengyel, ‘Continuity and Change in an Emergent Market Economy: The Limited Transformation of Large Enterprises in Hungary’, in *The Changing European Firm: Limits to Convergence*, edited by Richard Whitley and Peer Hull Kristensen (London: Routledge, 1996), pp. 210-237, p. 232.

⁴ Maury Peiperl and Saul Estrin, ‘Managerial Markets in Transition in Central and Eastern Europe: A Field Study and Implications’, *International Journal of Human Resource Management*, 9 (1998), 58-78, pp. 58-59.

⁵ Joseph Prokopenko, ‘Transition to a Market Economy and its Implications for HRM in Eastern Europe’, in *Human Resource Management in Europe: Perspectives for the 1990s*, edited by Paul S. Kirkbride (London: Routledge, 1994), pp. 147-163, pp. 157-158; D. M. W. N. Hitchens, J. E. Birnie, J. Hamar, K. Wagner and A. Zemplerová, *Competitiveness of Industry in the Czech Republic and Hungary* (Aldershot: Avebury, 1995), pp. 81, 334.

professional authority, unless they prove their ability to adapt to the new market conditions.⁶ Without this, their precarious position in society as well as in their enterprises is endangered. Respondents recognised the need for behavioural changes because

there are big differences in the management function. It was easy in the state-owned enterprises but is different in private companies where the owner employs managers and their job is to evaluate whether it is possible to reach set goals and work to seek ways to reach these goals. Managers are paid for looking for solutions even after working hours but everyone is supposed to think about solutions and bring them. On the other hand, workers in the workshops are not paid for bringing any kind of solutions, and as thinking and creativity are valued here so much of course we want to motivate people to come up with solutions and appraise them for it. The work of management is to solve problems, be creative and think. If they are unable to bring solutions they are not a good manager. People like that are not wanted here as they are paid for doing such work in their job (Čísar 4, Services Director).

Another director concurred the changes are most significant and important for managers rather than other employees, suggesting that there have been

no changes to the workers work, but managers now solve different problems than they did in the past and have different future problems to deal with. The

⁶ Anna Soulsby and Ed Clark, 'Economic Restructuring and Institutional Change: Post-Communist Management in the Czech Republic', *Journal of Socio-Economics*, 25 (1996), 473-496. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>.

main priority of management is financial restructuring, then focusing on customer needs with improvements in sales results and organisation, as it is essential to sell products (Odraž KM 1, Managing Director).

Respondents placed a lot of emphasis on the changed opportunities privatisation brings for managers to undertake restructuring measures, believing that

managers and directors are responsible for the success of the firm and they have better opportunities to lead the company compared to before privatisation (Rukopis Strojírny 5, Assembly worker).

As a result, there were anticipated changes in the function and interests of managers since

privatisation was expected to bring independence in decision-making away from certain people and lead to independence of the firm so that it is able to approach other markets in foreign countries (Brodchmel 4, Quality Manager).

Other differences highlighted were that managers now need to “take responsibility for the department and all the tasks in it, and if they cannot do this well, then they have to leave” (Rozdat Systems 4, Technical Director), with the effect that

today's management give more effort to their work than 10 years ago, and now if they want the firm to survive, they have to talk about financial issues all the time (Rozdat Systems 3, Maintenance Department supervisor).

These changes have arisen because firms operate within an increasingly competitive market environment, with the effect that

the main interest of the managers is to keep the firm in existence as there is a lot of competition in this industrial area. Maybe in the past it was development but now it is survival (Rozdat Systems 3, Maintenance Department supervisor).

Improvements in managerial influence over operational and production level issues were also expected within the firms so that managers would

allow workers to do more and new things in designing new products. They should buy new equipment and keep it in good working order, and provide a good place to work. Good working conditions are especially important as this means that the job is done better (Rukopis Strojírny 3, Mechanic).

Overall those who saw positive changes argued that "the management is more qualified, younger, and more effective" (Drazitest 3, Supplies Manager), with it possible to identify

improvements in the structure of management with gaining new knowledge and other fields of experience. The top management has been forced to learn new

skills and so there has been an increase in the quality and education of the management here (Přesnost KM 1, Financial Planning Manager).

Other respondents did not perceive that changes had been attained because although

the role of management is more important than it used to be, the role of managers is underestimated in this company and they tend to only be professionals in their field, and no managers here have managerial experience or qualifications. Some have learned more about management but it could be better in economic and organisational terms. The management have engineering backgrounds and their qualifications for the technical work they do are very good but most people do not realise or have no idea about how management works and how firms should operate in competition with other companies (Drazitest 1, Quality Director).

For another respondent, problems existed because although workers

expected managers to work better after privatisation, to become faster in dealing with problems, and to keep workers in their jobs, this didn't really happen. Management should understand the problems in this firm but I don't think they do fully. It is unclear how to change this. Their priority should be to find new customers and markets, and to try and find new employees with good experience in other companies that can be imported and used here (Rukopis Strojírny 4, Machine worker).

Even where respondents did not directly perceive changes within the management function, they expected the effects of this would be felt in other spheres. Consequently this employee thought that the managerial function had not changed, for though

what management do is not visible and so cannot be judged, the results of this are seen which are bad as there is not enough time or good conditions for working in, and also the quality of materials is not very good. Management do not understand the problems and are not interested in the real problems (Rukopis Strojírny 5, Assembly worker).

The diversity of responses reflects differences in perception by workers and the management over the changes necessary for restructuring and those introduced. However they also indicate that some behavioural patterns have not altered, as simply changing ownership with voucher privatisation does not effectively solve the principal-agent problem when managers do not introduce sustainable and appropriate restructuring to their firms. The potential for managers to induce restructuring and limits on its ability to do this depends upon the extent to which they can successfully redefine their function away from that under central planning in the post-privatisation environment.⁷ Before turning to look at the changes post-communist managers are introducing, legacies from the managerial function under central planning are presented as these persist, and their influence can impact on the perception of what restructuring should entail by managers in their own personal perspective as well as that of the labour force.

5.2 MANAGERIAL LEGACIES.

Since managers are responsible for implementing restructuring measures within firms, their own legitimacy to the workforce is essential.⁸ The management function in all the centrally planned economies became increasingly discredited over time because of its direct associations with the Party apparatus. For example, managers were normally selected for political reasons from amongst members of the *nomenklatura*,⁹ although exceptions were made in some cases for particularly skilled technocrats.¹⁰ This was understood by employees who saw how

many people were in positions no matter what qualifications they had. If the political leaders wanted them there, they were there. If they had a "red book" they could be a boss, even as an alcoholic (Brodchmel 3, Assembly Section Head).

In Czechoslovakia this lack of legitimacy was exacerbated after the Prague Spring and the subsequent period of normalisation when political links became more important than ever to attaining and retaining a position of influence. Even before 1989 therefore, managers needed to justify their position and associated authority to the

⁷ Stavros B. Thomadakis, *Long-Term Investment, Stable Governance and Financial Issues of Privatization in Transition Economies*, Working Paper, 51 (Leuven: LICOS Centre for Transition Economics, 1995), p. 14.

⁸ Iraj Hashi and Alison Sinclair, 'Managerial Behaviour and Supply of Shares in the Czech Voucher Privatisation Programme', *Mocst-Most*, 6 (1996), 103-121, p. 110.

⁹ Vincent Edwards and Gloria Lee, 'Models of Management Formation: Implications for Central and Eastern Europe', *Journal for East European Management Studies*, 4 (1999), 292-305, pp. 294-295.

¹⁰ Donna L. Wiley, 'Developing Managers in the Former Soviet Union: An Application of the Systems Approach', *International Studies of Management and Organization*, 24 (4) (1994), 64-82. Expanded Academic ASAP International Edition. 13 November 2000.

<<http://infotrac.galegroup.com/itweb/stand>>.

labour force.¹¹ This was often sought in ways that would benefit the workforce, such as bargaining for an easy plan to fulfil and providing social activities linked to the enterprise,¹² as well as in links between the firm and the wider community.¹³

As a result, state-owned enterprises institutionalised paternalism in the management function, so that socio-political objectives predominated in the relationship between the enterprise management and the labour force at the expense of economic efficiency.¹⁴ In the transformation these provisions have been withdrawn reluctantly by managers and government, and only where it is an economic necessity. They retain a useful function in the transformation environment in maintaining social peace and mitigating the negative pressures associated with transformation,¹⁵ especially in the absence of clearly defined alternative social assistance.¹⁶ For example, managers of firms with passive owners can attempt to pacify their labour force through avoiding

¹¹ Andrzej K. Kozminski, *Catching Up? Organizational and Management Change in the Ex-Socialist Block* (Albany: State University of New York, 1993), p. 159; Anna Soulsby and Ed Clark, 'The Emergence of Post-Communist Management in the Czech Republic', *Organization Studies*, 17 (1996), 227-247, p. 232.

¹² Olga Kuznetsova and Andrei Kuznetsov, 'From a Socialist Enterprise to a Capitalist Firm: The Hazards of the Managerial Learning Curve', *Communist Economies and Economic Transformation*, 8 (1996), 517-528, p. 518.

¹³ Gernot Grabher and David Stark, 'Organizing Diversity: Evolutionary Theory, Network Analysis, and Post-Socialism', in *Restructuring Networks in Post-Socialism: Legacies, Linkages and Localities*, edited by Gernot Grabher and David Stark (Oxford: Oxford University Press, 1997), pp. 1-32, p. 10; David Uhlir, 'Internationalization, and Industrial and Regional Change: Restructuring Post-Communist Networks in the Region of Lanškroun, Czech Republic', *Regional Studies*, 32 (1998), 673-685, p. 677.

¹⁴ Ronald Savitt, 'Critical Issues of Privatization: A Managerial Perspective', in *Transformation Management in Post-Communist Countries: Organizational Requirements for a Market Economy*, edited by Refik Culpın and Brij Nino Kumar (Westport: Quorum Books, 1995), pp. 17-28, p. 24; Niels Mygind, *Enterprise Governance in Transition: A Stakeholder Perspective*, Working Paper, 29 (Copenhagen: CEES, Copenhagen Business School, 1999). 25 September 2000. <http://www.econ.cbs.dk/cees/institutes/cees/pub/wp/wp29.html>, p. 17.

¹⁵ Maurice Ernst, Michael Alexeev and Paul Marer, *Transforming the Core: Restructuring Industrial Enterprises in Russia and Central Europe* (Boulder: Westview Press, 1996), p. 146; Martin Myant, 'The Transformation of Czech Enterprises', in *Industrial Competitiveness in East-Central Europe*, edited by Martin Myant (Cheltenham: Elgar, 1999), pp. 145-168, p. 155.

¹⁶ Vladimir Vrtiak, 'Management, Labour and Transition to a Market Economy in Czechoslovakia', *Bulletin of Comparative Labour Relations*, 27 (Special Issue) (1993), 153-164, p. 153; Ágnes Simonyi, 'Labour and Social Welfare in Competitive Firms', in *The Management and Organisation of Firms in the Global Context*, edited by Csaba Makó and Chris Warhurst (Gödöllő: Institute of Management Education, University of Gödöllő/Department of Management and Organisation, Budapest University of Economic Sciences, 1999), pp. 101-109, p. 107.

lay-offs where possible to enable them to maintain their own managerial positions.¹⁷ Consequently these legacies provide important institutional influences that influence the way managers behave in introducing restructuring measures to their firms.

5.2.1 *Networking.*

Networking is an important legacy that can help managers preserve their position following privatisation. This can act as an institutional buffer against managers needing to change where threats to their position are weak, as with poorly defined ownership and corporate governance structures, or protect their position under conditions of uncertainty. Network ties are stable interpersonal interactions,¹⁸ ranging in form and strength from “arms length” to “embedded”.¹⁹ In the former case transactions between specified partners are impersonal and infrequent and permit a wide range of brokerage opportunities that can increase the firm’s active market involvement and the potential number of relationships a firm can enter into. Embedded ties by contrast are collaborations predicated on trust and previously positive experiences between the agents involved, and can lead to mutually beneficial transactions occurring, including ones that would not normally be available in the open market.²⁰

¹⁷ Marie Frýdmanová, Kamil Janáček, Petr Mareš and Tomáš Sirovátka, ‘Labor Markets and Human Resources’, in *Ten Years of Building Capitalism: Czech Society After 1989*, edited by Jiří Večerník and Petr Matějů (Praha: Academia, 1999), pp. 21-43, pp. 33-34.

¹⁸ Ákos Róna-Tas, *Persistence of Networks in the Post-Communist Transformation in Eastern Europe*, Research Report, 4 (San Diego: Graduate School of International Relations and Pacific Studies, University of California, 1998), [n.p].

¹⁹ Brian Uzzi, ‘Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Finance’, *American Sociological Review*, 64 (1999), 481-505, p. 483.

Networking is frequently used in economic exchanges between different actors involved in activities that are linked in some way in an endeavour to reduce uncertainty and minimise exchange costs in specific relationships. Such ties had a particularly prominent role in the centrally planned economies,²¹ for although central planning was meant to enable the enterprise management to focus solely on production, in practice there were inconsistencies in the plans. Firms exhibited a high degree of vertical integration in direct response to the plans that were devised and implemented according to a strict hierarchy, but also because unreliability of supplies promoted the internalisation of upstream and downstream production. As such internalisation was not total, and as planned production and actual consumption demands often did not match, contractual bargaining with planners and other suppliers was necessitated.²² Additional horizontal networks were developed in an endeavour to compensate for shortages and overcome bottlenecks and obstacles to co-operation engendered within the centrally planned economy.

Uncertainty in the transformation environment should provide new opportunities for networking,²³ which has implications for restructuring because it consolidates and facilitates interactions between actors. It is important to consider whether totally new

²⁰ Mark Granovetter, 'Economic Actors and Social Structures: The Problem of Embeddedness', *American Journal of Sociology*, 3 (1985), 481-510, pp. 490-491; Uzzi, 'Embeddedness in the Making of Financial Capital', pp. 483, 491.

²¹ Endre Sik, *Network Capital in Capitalist, Communist and Post-Communist Societies*, Working Paper, 212 (Notre Dame: Helen Kellogg Institute for International Studies, University of Notre Dame, 1995), p. 4; Peter Huber and Andreas Wörgötter, 'Political Survival or Entrepreneurial Development? Observations on Russian Business Networks' in *The Tunnel and the End of the Light: Privatization, Business Networks and Economic Transformation in Russia*, edited by Stephen S. Cohen, Andrew Schwartz and John Zysman (Berkeley: University of California, 1998). 7 December 2000. <http://escholarship.cdlib.org/ias/cohen/tunnel_hw.html>, [n.p.].

²² Jan Adam, *Economic Reforms in the Soviet Union and Eastern Europe Since the 1960s* (Basingstoke: Macmillan, 1989), pp. 16-17.

²³ Rupert F. Chisholm, 'On the Meaning of Networks', *Group and Organization Management*, 21 (2) (1996), 216-235. Expanded Academic ASAP International Edition. 11 December 2000. <<http://infotrac.galegroup.com/itweb/stand>>, [n.p.]; Willie Seal, Pat Sucher, Ivan Zelenka and Marcela

links will form, or if previous links can be reconstructed and maintained during the transformation, as well as the extent to which maintaining existing ties can be effective or will subsequently represent obstacles that prevent the enterprise from adapting. Networks cannot be established without cost, and their usefulness increases over time given consistently credible behaviour.²⁴ It is therefore realistic to expect that ties developed under the former system will still be mobilised within this unstable environment, even if their applicability or effectiveness may have changed, rather than seeing many new ones being established.²⁵ One director related a specific positive aspect of such historical experience with networking, commenting that

for managers in the past, work had to be done in a certain way, but at least they learnt to work with people and that can be used nowadays, and they learnt how to negotiate with banks and certain key individuals in the past (Císař 4, Services Director).

Nevertheless, the enforced marginalisation of network ties into an ancillary production-based role during the period of central planning can limit their effectiveness as a new resource for overcoming the vertically integrated orientation of the former state-owned enterprises. By centring on meeting targets, past

Zarova, 'Accounting and Societal Transition: The Bohemian Accountant and the Velvet Revolution', *Communist Economies and Economic Transformation*, 9 (1997), 383-406, p. 402.

²⁴ Granovetter, 'Economic Actors and Social Structures', p. 490; Robert C. Liden and Terence R. Mitchell, 'Ingratiation Behaviors in Organizational Settings', *Academy of Management Review*, 13 (1988), 572-582, p. 584.

²⁵ Peter Rutland, 'Thatcherism, Czech-Style: Transition to Capitalism in the Czech Republic', *Telos*, 94 (1992-1993), 103-129. Academic Search Elite. EBSCO Publishing. 8 May 1999.

<<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; Mark Casson, 'Enterprise Culture and Institutional Change in Eastern Europe', in *The Economies of Change in East and Central Europe: Its Impact on International Business*, edited by Peter J. Buckley and Pervez N. Ghawi (London: Academic Press, 1994), pp. 33-53, pp. 37, 44; Róna-Tas, *Persistence of Networks*, [n.p.].

inefficiencies are perpetuated because there is no incentive to seek innovative ways to make improvements within the firm.²⁶

Another form of networking exists through the “institutional linkage”²⁷ between an enterprise and its surroundings. As highlighted for Brodchmel, the usefulness of this can change during transformation if the surrounding environment then no longer supports this. Respondents spoke of such a process being observed, with the company having

a lot of links to the local community because it is one of two large companies here that influences life in this region. This changed with privatisation in a negative way as the management changed, and co-operation with the town hall has diminished. Only a small amount of development in this region is sponsored, because the new management all come from Prague and therefore have no links to this region (Brodchmel 4, Quality Manager).

Other respondents in the firm also described these changes as negative developments since

the top management has links to the town hall and the firm gets financial support from those activities. Before it was different as the financial

²⁶ Gernot Grabher, ‘Rediscovering the Social in the Economics of Interfirm Networks’, in *The Embedded Firm: On the Socio-Economics of Industrial Networks*, edited by Gernot Grabher (London: Routledge, 1994), pp. 1-31, p. 20.

²⁷ Joel A. C. Baum and Christine Oliver, ‘Institutional Linkages and Organizational Mortality’, *Administrative Science Quarterly*, 36 (1991), 187-218, p. 187; Anna Grandori and Guiseppe Soda, ‘Inter-firm Networks: Antecedents, Mechanisms and Forms’, *Organization Studies*, 16 (1995), 183-214, p. 190.

possibilities to support things were greater and so there were more activities in this area that the company supported (Brodchmel 3, Assembly Section Head).

For Brodchmel, restructuring may be hindered by this change, but loosening the ties of enterprises to their surroundings can also permit economically rational decisions to be taken more easily, with it noted by another employee that “the company does not sponsor sport and cultural activities as much as it used to as now more is invested in advertising products” (Brodchmel 1, Personnel Manager).

Networking continues to have a prominent function for post-communist managers, supporting them in their role by allowing some restructuring to occur through these existing demands for information. Networking is therefore likely to have contributed to the strong continuities in personnel and their behaviour in former state-owned enterprises visible at all levels that reflects the partial nature of the revolutions. This resulted in “elite recycling” whereby managerial positions are filled by the former *nomenklatura* and those who would have succeeded their predecessors in time had the Communist regime persisted,²⁸ and was identified by one respondent who commented that “some new people came but mainly they are the same ones from the old state-owned enterprise” (Drazitest 2, Production Director).

The use of networks cannot substitute for restructuring, but they can have an entrepreneurial significance, which is most likely to explain their primary function within mature market economies.²⁹ If network ties can be mobilised in similarly

²⁸ Roderick Martin, *Transforming Management in Central and Eastern Europe* (Oxford: Oxford University Press, 1999), pp. 81, 91.

²⁹ Alena V. Ledeneva, *Russia's Economy of Favours: Blat, Networking and Informal Exchange* (Cambridge: Cambridge University Press, 1998), p. 170; Klaus E. Meyer, ‘International Production

effective ways in Czech firms, their pre-eminence and persistence could be advantageous. In the case study firms though, respondents placed little emphasis on their potential commercial use and the possibilities of linking to other organisations to increase such opportunities, with a typical response that

we are not members of any other organisations as we wouldn't really have any benefit from joining as our customers are clearly defined and we know our customers very well through our historical links. Abroad we have distributors and we meet with them at trade fairs to negotiate and so we have a good relationship as we know each other well (Odráz KM 2, Marketing Manager).

Only in Rozdat Systems and Drazitest was any reference made to membership of professional organisations. From this the firms saw benefits because "as it is important to get information" (Rozdat Systems 5, Financial Director) "that can be used in the development of the factory" (Rozdat Systems 1, Managing Director) although for Drazitest it was perceived to be "the local Chamber of Commerce that gives the closest contacts from the relationship" (Drazitest 6, Business Director). Consequently, it appears that managers are not transferring the historical uses of network ties into more relevant applications that would assist in restructuring their firms. Instead, former elites are using these to their advantage as institutional changes only occur slowly, allowing them to retain access to resources and information that

can be used to create new links to other business partners.³⁰ One director spoke of this, noting how

members of the KSČ, especially in the higher levels, had some kind of advantage with privatisation because they had connections and money, and it was a lot better for these than other employees. It was different to after the Second World War where everyone was at the same level and given 45 Marks from the state to start their own business, for here everyone was at different levels. Although it was expected that money and possessions would be given to the people who used it, many just wanted to get rich and did not take care of these possessions in a good way (Drazitest 2, Production Director).

The more the position of managers depends strongly on their links to the state bureaucracy, and with limited structural change occurring in the wider environment, the more beneficial and rational it is for existing managers to retain or revert to their previous patterns of behaviour.³¹ To overcome this requires both a “de-institutionalisation” of the enterprise from its old practices, and a “re-institutionalisation” to harmonise it with the new conditions.³² It therefore cannot be assumed that privatisation outcomes will necessarily follow those predicted by economic theory, in particular due to a retained social mentality of managers in making decisions and exercising authority over the labour force, but also by workers

³⁰ Eric Hanley, ‘Cadre Capitalism in Hungary and Poland: Property Accumulation Among Communist-Era Elites’, *East European Politics and Society*, 14 (2000), 143-178, p. 147.

³¹ Leslie E. Grayson and Samuel E. Bodily, *Integration into the World Economy: Companies in Transition in the Czech Republic, Slovakia and Hungary*, Research Report 96-19 (Laxenburg: International Institute for Applied Systems Analysis, 1996). 27 August 1999.

<<http://www.iiasa.ac.at/Publications/Documents/RR-96-019.pdf>>, [n.p.]; Michael W. Peng, *Business Strategies in Transition Economies* (Thousand Oaks: Sage, 2000), p. 128.

³² Christine Oliver, ‘The Antecedents of Decentralization’, *Organization Studies*, 13 (1992), 563-588, pp. 564-567; Soulsby and Clark, ‘Economic Restructuring’, [n.p.].

in their expectations of social protection from their workplace. Despite evident differences in the management function and different tasks required after the demise of central planning, especially a shift in focus from technological issues to cost and quality, many of the old habits of managerial behaviour still persist because of the retained mentality in decision-making and exercising authority over the labour force.³³

5.2.2 *Elite Recycling.*

Positive effects may arise from the retention of the old management through elite recycling and continued state ownership, since a level of trust and understanding between existing employees and management can facilitate the introduction of restructuring measures with negative side-effects such as wage reductions as a compensation against unemployment. Nonetheless, such benefits must inevitably be seen as a temporary adaptation that will become less appropriate as efficiency becomes the primary concern in privatised enterprises over time.³⁴ Another benefit is that useful human capital may be inherent within incumbent managers, particularly if these have been able to survive the initial ownership transition, for they have knowledge of the former system that, alongside their contacts and experience combined with an inherent interest in the firm could be used as an advantageous

³³ Jean Woodall, 'The Transfer of Managerial Knowledge to Eastern Europe', in *HRM in Europe: Perspectives for the 1990s*, edited by Paul S. Kirkbride (London: Routledge, 1994), pp. 164-177, pp. 172-174; Whitley *et al*, 'Continuity and Change', p. 232.

³⁴ Simon Clarke, Peter Fairbrother, Vadim Borisov and Petr Bizyukov, 'The Privatisation of Industrial Enterprises in Russia: Four Case-Studies', *Europe-Asia Studies*, 46 (1994), 179-214, p. 183.

legacy to facilitate restructuring,³⁵ but which they may be unwilling or unable to transfer to new managers.³⁶

In some firms, benefits from retaining the former managers were precluded where these were unable to retain their positions with privatisation.³⁷ In addition to illustration, others were removed in the initial transformation period through workers electing to approve or reject top management in the absence of new, clearly defined owners.³⁸ This was described by a respondent from Brodchmel who spoke of

changes made between 1989 and 1992 that still have an effect now. Although some people who were closely linked to the old regime needed to leave their leading positions, in the town workers were proclaiming their trust of the leaders and they were very powerful, so if they said they did not trust a certain manager they had to leave, although this was only on their word. The workers were in effect voting over every manager after 1989 on whether they wanted them or said they trusted them, so it was up to them as to whether the old management stayed or left. All of the top management left (Brodchmel 3, Assembly Section Head).

³⁵ Ákos Róna-Tas, 'Path-Dependence and Capital Theory: Sociology of the Post-Communist Economic Transformation', *East European Politics and Societies*, 12 (1998), 107-131, pp. 127, 130; Simonyi, 'Labour and Social Welfare', p. 103.

³⁶ Savitt, 'Critical Issues', pp. 21-22; Ed Clark and Anna Soulsby, *Organizational Change in Post-Communist Europe. Management and Transformation in the Czech Republic* (London: Routledge, 1999), pp. 168, 170.

³⁷ Irena Grosfeld and Gérard Roland, *Defensive and Strategic Restructuring in Central European Enterprises*, CEPR Discussion Paper, 1135 (London: CEPR, 1995), p. 18; Ed Clark and Anna Soulsby, 'The Re-formation of the Managerial Elite in the Czech Republic', *Europe-Asia Studies*, 48 (1996), 285-303, p. 301.

³⁸ Hilary Appel and John Gould, 'Identity Politics and Economic Reform: Examining Industry-State Relations in the Czech and Slovak Republics', *Europe-Asia Studies*, 52 (2000), 111-131, p. 121.

Whilst the potential benefits highlighted above are lost, doubts about the moral appropriateness of the participation of former elites in privatising companies and managers may also be raised.³⁹ Despite lustration, it was impossible to prevent former members of the KSC from retaining or acquiring managerial positions in privatised firms. However, the most important aspect of their continued presence in managerial roles is whether they have adequate incentives to undertake restructuring. As a measure attempting to remove the behavioural legacies of the Communists, lustration was likely to be of dubious effectiveness for the values of the system were shared more widely than by those in formal positions of authority.⁴⁰ Instead of lustration, to encourage restructuring reform of the economic system, what is required is to

confront [former Communist bureaucrats] with the rules of political and economic democracy, thereby forcing them to show whether they were able to adapt to the new system.⁴¹

It is unclear without empirical evidence how much restructuring these former elites who have been able to convert gains from their tenuous social position into more useable economic capital will undertake.⁴² This conversion of capital alone does not ensure that they will act efficiently as managers in the new environment or have the incentives to bring about appropriate and necessary changes. Without strong external constraints on their behaviour, although managers should not be expected to continue

³⁹ Ed Clark and Anna Soulsby, 'Organization-Community Embeddedness: The Social Impact of Enterprise Restructuring in the Post-Communist Czech Republic', *Human Relations*, 51 (1998), 25-50, pp. 29-30, p. 28.

⁴⁰ Jiri Pehe, 'The Controversy Over Communist Managers', *Report on Eastern Europe*, 1 (36) 7 September 1990, pp. 6-10, p. 8; Martin, *Transforming Management*, p. 13.

⁴¹ Pehe, 'Controversy', p. 10.

to act in ways consistent with the former system, they might only instigate changes they believe will give the enterprise and their own function legitimacy either externally and internally in its social or commercial dimensions.⁴³ Former communist elites are unlikely to have the necessary business knowledge for the effective operation of their companies in a market environment,⁴⁴ but instead regard this conversion of power as “the key to their social re-integration within the new society and their social distancing from their former status”.⁴⁵

One moderating factor against this is that the new managers of post-communist firms had often gained their position in the 1980s and did not hold as strong convictions over Communist dogma as previous generations. For managers in Císař it was observed that

the influence of the past depends on which generation they belong to. The new generation are much better, have more energy and their approach to people is different in not considering the workers as much. The older generation of managers was formerly the young generation going up and becoming prosperous and effective in general. A negative side for the older generation comes from being used to getting plans and orders from the state. They are not used to making their own decisions and being responsible for the changes this involves and have a mental block on making independent decisions. But these

⁴² Hanley, ‘Cadre Capitalism’, pp. 145, 147; Clark and Soulsby, *Organizational Change*, p. 137.

⁴³ Bala Chakravarty and Martin Gargiulo, ‘Maintaining Leadership Legitimacy in the Transition to New Organizational Forms’, *Journal of Management Studies*, 35 (1998), 437-456, p. 441; Clark and Soulsby, ‘Adoption of the Multi-Divisional Form’, p. 552.

⁴⁴ Nikolaos T. Milonas, *Mass Privatization Methods and their Effects on Capital Market Institutions, Agency Relationships and Managerial Monitoring*, Working Paper, 50 (Leuven: LICOS Centre for Transition Economics, 1995), p. 17.

⁴⁵ Ed Clark, ‘The Role of Social Capital in Developing Czech Private Business’, *Work, Employment and Society*, 14 (2000), 439-458, p. 449.

are generalisations and of course cannot apply to everyone (Císař 1, Trade Union President).

A continuation of former managerial personnel will be negative if their interests or behaviour are contrary to those of other stakeholders in the firm,⁴⁶ especially where they face limited pressure to alter their behaviour due to a lack of managerial accountability.⁴⁷ In other cases there are benefits from the retention of former managers and so the outcomes within firms can only be resolved empirically. The extent to which these potential difficulties have been overcome in the case study firms is presented below where the new functions and actions of post-communist managers are assessed with regard to institutional influences in existence.

5.3 POST-COMMUNIST MANAGERS AND RESTRUCTURING.

The extent to which former state-owned enterprises can be effectively transformed into enterprises able to compete in a market economy depends in combination on flexibility in their structure and the ability of the firms' top officials to lead and restructure the firm in an appropriate and dynamic way,⁴⁸ as well as whether these changes are embraced within the firm. Since tight personal links and associations were constructed in state-owned enterprises, a major challenge in restructuring lies in

⁴⁶ Jennifer E. Bethal and Julia Liebeskind, 'The Effects of Ownership Structure on Corporate Restructuring', *Strategic Management Journal*, 14 (Summer Special Issue) (1993), 15-31, p. 16.

⁴⁷ Joseph Saba, 'Orphans in the Storm: The Challenge of Corporate Governance in Transition Economies', in *Between State and Market: Mass Privatization in Transition Economies*, edited by Ira W. Lieberman, Stephan S. Nestor and Raj M. Desai (Washington: World Bank/OECD, 1997), pp. 121-129, p. 121.

⁴⁸ Karen L. Newman and Stanley D. Nollen, 'Managerial Challenges During Organisational Re-Creation: Industrial Companies in the Czech Republic', in *Privatization and Entrepreneurship: The Managerial Challenge in Central and Eastern Europe*, edited by Arie A. Ullman and Alfred Lewis (Binghampton: International Business Press, 1997), p. 131.

overcoming human capital constraints⁴⁹ rather than simply instigating technological and impersonal solutions premised on economic principles.⁵⁰ In the following sections changes that managers have implemented in the case study firms for restructuring are presented. Institutional influences are highlighted through their impact on the restructuring decisions undertaken, and these are shown to arise from formal and informal causes with a strong inter-temporal dimension, making path-dependency and embeddedness important. Cognitive issues predominate, which is likely to be exacerbated by the limited change amongst personnel within enterprises, suggesting that informal institutions are both influential and persistent in understanding post-privatisation restructuring outcomes in firms.

5.3.1 Strategic Planning.

Because of the limited functions of managers in state-owned enterprises

before privatisation you cannot really talk about a management as this did not really exist. There were just plans from the top that needed to be implemented (Drazitest 6, Business Director).

An important change for managers brought about with privatisation is that whilst some former practices associated with implementing plans became obsolete in the new environment, it has become economically essential to develop other functions that were not the responsibility of managers under central planning. These include the

⁴⁹ Clark and Soulsby, *Organizational Change*, p. 178.

⁵⁰ Ed Clark and Anna Soulsby, 'Transforming Former State Enterprises in the Czech Republic', *Organization Studies*, 16 (1995), 215-242, pp. 216, 222.

establishment of foreign trade relations and marketing strategies, innovations and quality assurance measures, and a shift to consumer-driven production, as product markets are no longer assured.⁵¹ Managers now have to be concerned with strategic decision-making and resource optimisation, whereas previously they

did not have to consider finance so much, and did not have to change anything to make a plan. They just asked for a certain amount of money and got it (Císař 4, Services Director).

The stress on plan fulfilment and taut planning that did not encourage innovation or modifications to product specifications that benefit the consumer constitutes an important behavioural legacy. Although the costs of innovation were borne internally, benefits accrued to society as a whole, and changes in the firm's output would have required cumbersome changes in the input specifications of the plan.⁵² This behaviour stifles the "gales of creative destruction" upon which mature, competitive market economies depend.⁵³

One new task of managers in privatised firms is the development of strategic plans so that the long-term survival and development of their enterprises is formalised. This is important because it requires managers to assess the viability of their firms according to economic criteria, and to plan its future strategic development, rather than expecting state assistance if difficulties arise. This shift in outlook should facilitate

⁵¹ Richard Whitley, 'The Internationalization of Firms and Markets: Its Significance and Institutional Structuring', *Organization*, 1 (1994), 101-124, p. 109; Jiří Havel, 'Changes in Governance Structure of Czech Enterprises, 1989-1995', *Prague Economic Papers*, 5 (1996), 127-136, p. 128.

⁵² Alan H. Smith, *The Planned Economies of Eastern Europe* (London: Croom Helm, 1983), pp. 57, 75.

restructuring because the operation of the firm and criteria for continued production after privatisation differs from those under central planning. Explicit recognition of the role of strategic plans was made in Rozdat Systems where these were created because of the firm's

development needing to be clear for the owners, and for the European Union, although legislation has not been harmonised between the European Union and the Czech Republic. The main priority was that the firm had to exist. Managers signed special agreements over responsibilities and tasks as it includes direct points on motivation for managers such as financial goals that are fixed and worked into and derived from the overall strategy of the firm (Rozdat Systems 1, Managing Director).

Excepting minor variations, these plans all share common target issues covering the short, medium, and long-term development of the firm, stated in Přesnost KM as "marketing and sales, market position, management, and human resource development" (Přesnost KM 2, Co-operation Plant Section Manager), and in Císař where the

main goals are profit, to renew and bring new qualified people, keep good technology and renew technology to keep and increase standards, and to keep partners and customers (Císař 4, Services Director).

⁵³ Joseph A. Schumpeter, *Capitalism, Socialism and Democracy* (London: Allen and Unwin, 1944), p. 83.

As the only company in this study without a strategic plan, representatives in Odráz KM recognise this as a weakness as it “makes it difficult for workers to know plans for management and company and plans for the future” (Odráz KM 2, Marketing Manager). According to the Managing Director

although there is no separate business plan for Odráz KM, this is in mind, but at present we follow Rukopis Strojírny’s for this. Some at Rukopis Strojírny want to resolve this situation and get on with it but so far it has not been done because of the high cost for the company. Some customers are also interested in this for the company but the owners want more money for themselves instead of doing this (Odráz KM 1, Managing Director).

The existence of strategic plans does not predetermine their usefulness or even signify a change in behaviour within firms. Although reference is made to human resource development, in practice these plans and the restructuring strategies of firms appear to centre on more tangible strategic issues. In Rukopis Strojírny, the management defined its goals in the strategic plan as

planning a lot for the future, stabilising the firm, looking for expansion and trying to find new partners because a strong partner is needed for globalisation, although the company has made good progress internationally (Rukopis Strojírny 2, Operations Director).

The daughter companies reflect this desire in their strategies, recognising “finding good markets for the future as a priority” (Rozdat Systems 2, Production Manager)

and that “globalisation has come to this branch, with a need to be competitive” (Rozdat Systems 4, Technical Director). Consequently,

future stabilisation is expected, and a need to get foreign partners and finalise agreements with these. A strategic plan for finding a new strategic investor according to all issues related to the future development has been made and confirmed by directors as the future of this firm (Rozdat Systems 1, Managing Director).

This means that even in the new market environment it is common to see

formerly state-owned companies approach strategy formulation as planning [since they] have experience with developing annual and five year plans under the socialist regime.⁵⁴

However, in the case study firms the strategies appear to represent an awareness of the changed operating conditions of the firms, and an appropriate motivation to change their production behaviour in accordance with the new market conditions. This was evidenced in two firms where respondents described the formulation of the strategic plan and setting its goals “for one year, and for three to five years ahead, as now we have to set goals and reach them, otherwise we do not get any money” (Císař 4, Services Director), and in another firm where the “strategic policy of the firm is

⁵⁴ Károly Balaton, *Management in Different Phases of Organizational Transformation in Hungary*, International Workshop on Transition and Enterprise Restructuring in Eastern Europe, 20-22 August 1998 (Copenhagen: CEES/Copenhagen Business School, 1998). 25 September 2000. <<http://www.econ.cbs.dk/cees/institutes/cees/workshop/pdf/Balaton.pdf>>, [n.p.].

made for five years, fixed for one year, but every 3 months all points in it are reviewed" (Rozdat Systems 1, Managing Director).

In the companies where strategic plans have been introduced, owners and managers anticipate that all employees within the firm will be aware of these and respond to the goals set within them so that restructuring responses are integrated throughout the firm. To help achieve this, some of the companies have tried to formalise this so that not only are the objectives of the strategic plan included in the vision of the company, but devolved so that "each department has its own goals that all employees know about" (Brodchmel 1, Personnel Manager), with

goals for each workshop, and even the lowest positions of workers are informed over these goals and the stages on the way to these goals and about the situation (Císar 4, Services Director).

However, responses showed that this was not always achieved in practice, especially for non-managerial personnel, with employees claiming they "don't know the strategy of the management" (Císar 1, Trade Union President) or that

the details of the strategic plan are not known because the management keeps them secret, which is a pity as they must know what will happen in a years time (Brodchmel 2, Project Manager).

Sometimes the existence of a strategic plan was "not recognised" (Rukopis Strojírny 1, Personnel Director), or employees claimed its function was not clear, so that they

“do not know how it has any influence over how the job here is done” (Přesnost KM 3, Assembly line worker). This indicates that there are significant limitations in their effectiveness as an institutional pressure for change because they do not cause a change in mentality within the workplace.

An alternative difficulty was highlighted in Císař, where employees conflict with the owners and management in their respective interpretations of the firm’s strategy over its appropriateness to the new conditions. One director described how in the strategic plan for the firm

the main goal is profit although not in every situation. We try to get profit to renew and bring new, qualified people, keep good quality, and renew technology to maintain standards and even increase them, and keep partners and customers. It is a matter of finance in general, not just profit from orders but an ability to manage finance for operating the firm for production. This is a question that takes years and cannot be accomplished in the short run in big companies (Císař 4, Services Director).

Commenting on this strategy, the perspective of one worker though was that it

cannot really be evaluated from not being part of the management and therefore not knowing their intentions and goals, but just seeing it in practice it appears to be saving as much money as possible as the owner and the market puts stress on them according to how much product can be sold (Císař 1, Trade Union President).

Another shared a similar view, describing how the firm's strategy appears to be

coming from the management with the help of an investor from Germany, which was not possible to be successful. They were trying to keep people in the factory and keep the same production, with debts for the operation of the company covered by selling the property of the company. The policy was like this for 5-6 years when they still had money for salaries and funds to keep the company operating. The management try to get as much money as possible, which is not a good way to manage. Unfortunately there are some parts where the management has paid too much attention to even if they were not healthy, and this was not justifiable or necessary. The management did not want to accept that this part was taking the whole company down and they would not get rid of it although this would make the whole company healthier. Their words differ from their actions, and although the firm could have a good prognosis for the future, the actual operation of the company does not compare to this at all (Císař 3, Retired Analyst).

In this case the employees' interpretations correlate most closely with the observable situation of the firm. This does not necessarily mean that the strategy is different from that claimed by the management, but if such long-term goals are being set, they do not seem to be becoming embedded in the firm and bringing the desired results quickly enough here. Alternatively, it could be that this is merely the rhetoric that managers believe to be consistent with a market economic system, and that such changes are not being implemented in the firm in reality, either because they are not

understood, or that they are incompatible with the actually existing conditions in the firm.

Managers also need to determine how internal control systems and the hierarchy of command can be implemented to most effectively re-assert control over production and labour. Issues relating to the impact of labour as an institution on restructuring are discussed in the next chapter in more detail. However, as the supply of labour is relatively inelastic, managers need to devise ways of motivating labour and using this resource more efficiently as part of the restructuring of the firm. One aspect of maximising the effectiveness of such internal structural innovations relies on the development of effective human resource management practices as a strategy of post-privatisation restructuring.⁵⁵

5.3.2 Human Resource Management.

Adaptations in human resource management (HRM) have often been neglected in voucher privatised companies. Instead, post-communist managers often seek rapid and tangible indicators of their success in areas such as marketing and sales.⁵⁶ This is despite the evidently key role of HRM in organisations in developed market economies, and so can represent an institutional limitation against effective overall restructuring of Czech enterprises following privatisation if managers do not appreciate its potential to affect the overall competitiveness of the firm.

⁵⁵ David Parker, 'Ownership, Organisational Change and Performance', in *The Political Economy of Privatization*, edited by Thomas Clarke and Christos Pitelis (London: Routledge, 1993), pp. 31-53, pp. 39-40.

⁵⁶ Josef Koubek and Chris Brewster, 'Human Resource Management in Turbulent Times: HRM in the Czech Republic', *International Journal of HRM*, 6 (1995), 223-247, pp. 228-229.

Those in managerial positions can be unaware of alternative methods of HRM to ones they previously adopted. It can therefore be problematic to motivate the management to recognise the validity of HRM and change their perception over what this involves.⁵⁷ Under the Soviet model, monitoring of workers was attained through tight administrative controls over production, with limited emphasis placed on increasing productivity, and promotion accorded on political criteria.⁵⁸ In conjunction with the planning system that discouraged flexibility, HRM practices were deleterious to rewarding innovative behaviour and creativity by labour. There was very little scope for increasing the remit of HRM practices as this was seen as a task with political objectives, rather than as a way of maximising the potential of the labour force.⁵⁹ Personnel management and HRM functions in state-owned enterprises were assigned to a number of different departments. Personnel departments as an extension of the secret police kept very detailed records over the working and personal lives of employees,⁶⁰ since the absence of a free labour market meant they did not need to be concerned with recruitment issues. Instead, they were active in the areas of cadre activities and, in conjunction with the trade unions, social welfare provision.⁶¹ Appraisal systems were only a formality, mainly used as a measure of political activism since employment or wage-based incentives could not be mobilised to discipline or encourage workers because full employment created labour shortages

⁵⁷ Marián Kubeš and Peter Benkovič, 'Realities, Paradoxes and Perspectives of HRM in Eastern Europe: The Case of Czechoslovakia', in *HRM in Europe: Perspectives for the 1990s*, edited by Paul S. Kirkbride (London: Routledge, 1994), pp. 178-193, pp. 183, 192; Woodall, 'Transfer of Managerial Knowledge', p. 176.

⁵⁸ Clarke *et al*, 'Privatisation of Industrial Enterprises', p. 183; Koubek and Brewster, 'Human Resource Management in Turbulent Times', p. 228.

⁵⁹ Kubeš and Benkovič, 'Realities, Paradoxes and Perspectives', p. 178; Karen L. Newman and Stanley D. Nollen, *Managing Radical Organizational Change* (Thousand Oaks: Sage, 1998), pp. 28-29.

⁶⁰ Koubek and Brewster, 'Human Resource Management in Turbulent Times', pp. 224-225; Rosalie L. Tung and Stephen J. Havlovic, 'Human Resource Management in Transitional Economies: The Case of Poland and the Czech Republic', *International Journal of HRM*, 7 (1996), 1-19, p. 6.

⁶¹ Alec Nove, *The Socialist Economic System*, 3rd edition (Winchester, MA.: Allen and Unwin, 1986), pp. 229-230; Anna Soulsby and Ed Clark, 'Controlling Personnel: Management and Motive in the

and wage levels were centrally determined.⁶² The extent of control that the personnel department had in enterprises on behalf of the KSC and resentment of this felt by the labour force is also reflected in the suspicion of many employees of new HRM and personnel departments, even where their function has evidently changed.⁶³

Path-dependency and embeddedness of firms to formal and informal institutions during the transformation process will influence employment-based relationships within the firm and thus alter the HRM practices deemed appropriate. New values are being imbibed into the management during transformation, but the emerging HRM practices in the Czech Republic also reflect more deeply rooted, cultural values. The Czech Lands were amongst the most economically advanced areas in the inter-war period, with extensive labour market provisions and a skilled labour force. This, alongside traditional Czech characteristics that include a strong belief in equality and social democracy, and a historically close affinity with Western European nations that is reflected in parallels in their industrial traditions and work ethos,⁶⁴ has enabled similarities between the HRM practices adopted in Western Europe and those of the newly privatised enterprises of the Czech Republic to develop.

Structural inertia in firms can also hinder changes in HRM, with state-owned enterprises exhibiting a strongly hierarchical internal structure that cannot be changed instantaneously, and to which the former directive management practices are

Transformation of the Czech Republic', *International Journal of Human Resource Management*, 9 (1998), 79-98, pp. 81. 83.

⁶² Koubek and Brewster, 'Human Resource Management in Turbulent Times', p. 227.

⁶³ Kubeš and Benkovič, 'Realities, Paradoxes and Perspectives', p. 183; Koubek and Brewster, 'Human Resource Management in Turbulent Times', p. 229.

⁶⁴ Koubek and Brewster, 'Human Resource Management in Turbulent Times', p. 229; Tung and Havlovic, 'Human Resource Management', p. 4.

efficiently adapted.⁶⁵ This management style will have increasingly restricted applicability when firms begin to operate according to market conditions. However, uncertainty increases the risk for managers if they choose to adopt new strategies with uncertainty over future conditions, so reform may actually discourage major changes in HRM practices.⁶⁶

The theory of different HRM practices may reach the enterprises, but how far these are then translated into any tangible changes is unclear, whether from not being implemented or adopted in the enterprise, or because only a few ideas rather than a consistent set of measures are introduced.⁶⁷ Workers may not respond well to many of the new changes in HRM, either because they are alien to their inherited working patterns, or because they appear to be innovations that only mirror the former styles of work and management.⁶⁸ Specific problems in this area were noted in Přesnost KM where a new system of appraisals had been designed in 2000 so that

the best workers do not just get the wages of the average worker. Under socialist times, there were boards for worker evaluations and were abolished initially because of this history, but we are finding that we need to restart this again. It is unclear whether the workers will understand the differences between the old and the new system. Now people live in a different economic and obviously political situation but many people do not understand the changes yet (Přesnost KM 1, Financial Planning Manager).

⁶⁵ Kubeš and Benkovič, 'Realities, Paradoxes and Perspectives', p. 188.

⁶⁶ Richard Whitley, Jeffrey Henderson and Laszlo Czaban, 'Ownership, Control and the Management of Labour in an Emergent Capitalist Economy: The Case of Hungary', *Organization*, 4 (1997), 409-432, p. 412.

⁶⁷ Soulsby and Clark, 'Controlling Personnel', p. 91.

⁶⁸ Soulsby and Clark, 'Economic Restructuring', [n.p.].

Similar difficulties that also demonstrate the need for an approach such as embedded institutionalism to understand the progress of restructuring were highlighted for Brodchmel, where a manager spoke of how

new things have been introduced such as material on motivation, but this is not so strong. People have to change their thinking and introduce new things such as competition and appraisals. People do not understand the real meaning of these expressions and do not take it seriously, but say they “already know that”. Most people still do not understand what work is in capitalism and the changes this needs in the way they work and appraise work (Brodchmel 2, Project Manager).

Another director recognising the need for changes in HRM methods described difficulties in achieving this since

it is difficult to appraise workers and the directors are always looking at how to motivate workers, get quality, and lead people (Rukopis Strojírny 2, Operations Director).

Attempts to overcome this in Rozdat Systems have been achieved by altering the institutions of HRM. For example “assessments of worker performance are mainly interested in the quality of work done” (Rozdat Systems 5, Financial Director). To promote this

regular information over the firm is given to the employees. Having studied the politics of motivation, we have come up with eight criteria, including salary bonuses. The aim is to get employees to work better and if they do not work well they need to move to another job or leave (Rozdat Systems 1, Managing Director).

In addition, change is expected amongst the managers and institutionalised into their role where

managers have all signed special agreements over their responsibilities and tasks with direct points on motivation for managers such as financial goals to achieve. These are very hard and strong, and worked into the overall strategy of the firm (Rozdat Systems 1, Managing Director).

Effective change in HRM therefore requires adaptations by managers and workers, but more generally the prevailing institutional setting can modify organisational restructuring according to whether this rewards or discourages initiative and innovative behaviour.⁶⁹ This does not depend simply on the adoption of new strategies, but on the successful dissemination of ideas and information and its application through all levels of the corporate hierarchy. Consequently, communication is central to the conduct of restructuring to ensure that adequate information is being passed through the company, but also to ensure that the interests and desires of all agents are expressed effectively and accurately.

⁶⁹ Mike Geppert, 'Paths of Managerial Learning in the East German Context', *Organization Studies*, 17 (1996), 249-268, p. 253.

5.3.3 *Communication.*

Communication is essential for all aspects of production in firms, but under central planning, information had to flow strictly along the hierarchies of authority within and between firms and planning agencies. Now this needs to flow effectively in multiple directions despite these legacies, because the dissemination of information is an important factor in determining the effectiveness of communication that will be tangibly reflected in how effectively restructuring is introduced. Excepting minor variations in the frequency of meetings, all the companies studied follow the pattern adopted in the Rukopis Strojírny group where

directors meet weekly and subsequently each of these directors meets with their staff in direct response to this [and] approximately every three months there is a meeting between the directors and the workers that is very popular (Rukopis Strojírny 1, Personnel Director).

To complement this, there are also regular meetings for the different functions, for example

every 10 days in production, which the management attend, along with representatives of the trade union who are then responsible for giving information to workers (Rozdat Systems 2, Production Manager).

A few specific incidents of effective communication were identified in the case studies. Drazitest is seen as “a “flat” organisation and so getting information and

spreading it is not a problem” (Drazitest 7, Personnel Manager). Consequently benefits arise because

the company is so small and all communicate with each other. There are not any problems at all with communication up to the Board and anyone with a problem can go and speak directly to the Director if necessary (Drazitest 1, Quality Director).

Similarly in Rozdat Systems, the relevance of good communication was noted by this respondent who saw that

in the maintenance department, communication with management and workers is excellent, and so the results of the work are good (Rozdat Systems 3, Maintenance Department supervisor).

Another director, seeing communication as an integral aspect of the strategic development of the firm introduced “in accordance with the program of motivation, an office hour on a Friday morning” (Rozdat Systems 1, Managing Director). In other firms, managers stressed some form of “open door policy” (Rukopis Strojírny 8, Quality Director; Rukopis Strojírny 2, Operations Director), which are important innovations in firms because they represent attempts to break down the strictly hierarchical communication lines that existed in state-owned enterprises. As well as indicating a change in communication, this also requires differing functions of managers in making independent strategic decisions for the firm that requires more contact with the workers and disseminating information about strategic planning.

Some positive changes in attitudes to communication have resulted from privatisation that can help promote restructuring. Meetings before privatisation were described as being

on a very large scale even though managers did not have time for this. When working as a manager it was necessary to attend these, and so this was a waste of time (Rozdat Systems 2, Production Manager).

Their changed function was clearly illustrated by one respondent who described how there were

meetings until 1989 where everyone could and would participate. Now it is more differentiated, with some meetings only for higher management or some for lower workers. It was strange at Communist meetings as everyone was there but they were about political issues and not related to issues and decisions in the firm. People were put together against a common enemy but would afterwards gossip about the news and stupid comments and decisions made in the meetings (Drazitest 5, IT Analyst).

Specific benefits seen from communication changes after privatisation were that

communication is different compared to before privatisation where there was not this kind of communication for workers but instead was formal, forced communication. There were political institutions in the company forcing people to come to meetings and forcing people to speak up (Císař 4, Services Director).

Another worker noted that

communication has changed totally and has improved a lot compared with previously. Communication is less deep now, indicating that people have less time to meet and chat but they try now to do things rather than just talk (Drazitest 4, Researcher).

Similarly, there is more interaction as “now it is not necessary to wait for these formal meetings as it was before privatisation” (Rukopis Strojírny 4, Machine worker). Also workers communicate more widely, for example

with other departments if there are any problems in production. Collaboration with other departments must be consistent and if there are problems, supervisors talk about these, but all is informal rather than through meetings with the aim being to solve the problem as quickly as possible (Rozdat Systems 6, Supervisor).

These comments indicate that respondents recognise that communication has altered with privatisation to become an economic, rather than a political mechanism.

Notwithstanding all these improvements in communication, and the impression of one employee that communication is “better because the managers are more open and willing to help employees now” (Rukopis Strojírny 3, Mechanic), difficulties with communication that are detrimental to encouraging restructuring were also highlighted by both managers and workers in the case study firms. One manager promoting an open door policy recognised how

in different sections it works differently. Other managers want to keep their distance and workers are often told to go to a lower level, so the workers do not go back to talk to the manager (Brodchmel 3, Assembly Section Head).

Also, though another offered “an opportunity for communication with the workers, this does not happen very much” (Rukopis Strojírny 8, Quality Director).

In each of the case study firms, information is still passed strictly through each level of the corporate hierarchy, with typical descriptions being that

communication between workers and managers follows the structure of the company, and to communicate upwards, employees have to go through the hierarchy of the firm (Odráz KM 1, Managing Director)

and that

it is possible to speak to the managers as they would listen, but only in very serious cases. Normally people would go and speak to their supervisor in a shift (Přesnost KM 3, Assembly line worker).

This is because whilst workers “can go to whoever is responsible to help, they will be directed to go down a level if necessary” (Dražiteš 2, Production Director). The most extreme case in these companies was where a respondent described how

communication is necessary with the management because problems must be solved in conjunction with them. If workers try to solve their problems in the workplace directly, they are told to speak to the manager (Císař 2, Machine worker).

The inclusion of communication in the ISO 9001 and other quality standards adopted by firms that institutionalise this is important because it represents exogenous institutional constraint against managers persisting with previous communication patterns that are contrary to the development of the firm. Only in Drazitest though was specific reference made to the effects of this on communication in the firm, so that

whilst all workers have the opportunity to approach the manager responsible for the problem, another aspect comes from ISO 9001, and meeting the criteria of this is very strict. If there is a specific problem, a certain form has to be filled in and given to a certain person. It is very bureaucratic, but also has the advantage as we have reports then of everything that is said or done, the way the problem went from the beginning with the worker up to the Director and then to final solution of the problem (Drazitest 3, Supplies Manager).

It was noted that this was to be used to enhance, rather than dramatically alter communication within the firm, as

we tried to continue and join the ISO 9001 standards to other ways of communication and adapted it to the ways of communication needed in the firm

and not work the other way around. There should not be any problems with communication, but the system should instead bring increased control to the firm, for example if there is a document to be signed, someone may forget and ISO 9001 ensures that it does get done (Drazitest 7, Personnel Manager).

Although these can promote better communication that can encourage restructuring to be incorporated and accepted within the firm, these standards are also potentially detrimental to effective communication because they encourage the persistence of former practices of hierarchical communication patterns.

An additional aspect of communication that can influence the nature and implementation of restructuring measures managers introduce arises from the way information flows between the workers, management and owners. Ineffective communication can easily become an institutional barrier against restructuring. In some of the companies there appear to be discrepancies between the understanding of communication and practices by the owners and managers and the perception of this by the workers. Some of the difficulties arise because communication is ineffective in passing through the firm, with the existence of real and perceived barriers.

Respondents primarily identified the distance along which information had to pass as the crucial issue such that

the hierarchy is too long between the source and the action and often the information is just not given to the right people at the right time. Information is not carried in an effective way (Presnost KM 1, Financial Planning Manager).

Another spoke of how

it takes a long time for information to get down from the leading positions.

Communication up the hierarchy would be a solution. This way of

communication generally works better compared to the other way round.

Pressure is more effective from the bottom to the top than the other way round.

The information that gets passed from the management down is not complete
(Brodchmel 4, Quality Manager).

In other firms a similar sentiment was expressed, with respondents recognising that

communication down to the rest of the company from the board could be better.

It is hard to get information from the board down to the very lowest levels as information is not passed effectively. Communication upwards depends on the position of the workers, and whether they are willing to discuss their problems according to whether they think they can be solved or not. To improve this, communication between individual people needs to be better (Drazitest 5, IT Analyst).

In Rozdat Systems this was also seen where specifically there are

often meetings between managers and workers where a lot of information is shared and so we get numbers and facts, but of course there is a lot of information that is shared between the top management and the owners.

Workers do get enough information but there may be some problems in how

this information is discussed before it is passed to the workers from the top management level. Labour cannot tell supervisors what they don't understand and so they go to the trade unions if they have problems (Rozdat Systems 7, Supervisor).

Where the workers regarded communicating with the management as problematic, this creates an impression within the firm that

management are not interested in the real problems, and although it is possible to communicate daily with the head of the department, this is not possible with the top management, but this wouldn't help though because the way that they see the problems and their potential solutions are not the best (Rukopis Strojírny 5, Assembly worker).

In Císař respondents were more explicit in describing the effects of such problems, saying that though "it should not be a problem for a worker to go and speak to the top management, this does exist here as a problem (Císař 1, Trade Union President), and "there is always some information going from the bottom-up, but in the last period the management is not interested in any problems" (Císař 3, Retired Analyst).

This problem was also cited for another firm by a manager who suggested "not all information seems to be passed in all directions. Maybe the owners don't even want to know the more detailed information" (Odráz KM 2, Marketing Manager).

Respondents expected that if communication was better, it would be easier to resolve this, otherwise

because no-one knows about the next few years, about the immediate future, decisions are made in a fast way and not in a good way (Brodchmel 4, Quality Manager).

However,

people do not even know about new quality norms introduced in the company, which is a problem. People do not know about the new goals, they are not informed and therefore cannot do anything to help the company as they do not understand how big the problem that is here now is (Brodchmel 2, Project Manager).

The function of communication has changed with privatisation, but adaptations at a personal and corporate level have not always been visible. Both a structural and a mentality issue, this negatively affects the development of companies as restructuring follows altered incentives for production after privatisation. Without an accurate understanding of the problems within the firm and the overall strategy of the management and owners, restructuring changes cannot be effectively designed and implemented. One respondent gave this general assessment of changes in communication and the need for this to be effective, speaking of how

compared to the past, contact between management and the workers has decreased and now it is up to trade unions to encourage meeting with management and workers. What does not happen is that a manager goes to the workshop to speak to people, and therefore any initiative comes from workers

and trade unions. This reduced contact is worse. The management does not communicate to the workers enough and so they do not know about the problems. Some of the unsolved problems may lead into serious difficulties or work-stopping situations such as if a machine breaks that need an immediate solution. Not knowing the reality in the factory, the circumstances, background or the cause of the problem etc means that a management solution to the problem may not be the optimal way. They do not care to go to the workshop and find out the actual situation. Communication is an individual matter and if people want to communicate, they can always find a way. Some do communicate off the job because they are friends, other people don't even meet each other at work because their jobs and tasks are different. Communication comes from good relationships between people. Bottom-up communication is gradual, it is always better on the same level. Going up, communication gets worse as it goes higher. Communication is trying to talk about opinions and find middle way but what works perfectly here is the giving of formal orders in the company. The main problem is communicating over opinions and views as communication is not just about giving and receiving orders, but also discussing work and how to improve and change ideas to improve it (Drazitest 4, Researcher).

This demonstrates that without communication between managers and employees, effective restructuring changes will not be introduced and become embedded into the firm, to the overall detriment of privatisation and restructuring.

So far this chapter has considered institutional changes that primarily reflect managerial strategies at the interpersonal level. Typically the function of owners in firms in developed market economies to initiate such changes, the case study firms show strong evidence of this occurring at the managerial level. This reinforces the perception that the *de facto* control attained by managers in voucher privatised firms is more important than *de jure* ownership.

The remaining two sections shift to deal with more concrete physical structural aspects of restructuring that are also changes managers can make when restructuring their firms. As with the other changes discussed, their effectiveness is determined by the way resources internal to the firm can be mobilised as well as institutional constraints from the operating environment of the firm.

5.3.4 *Production Changes.*

Evidence of managers changing production techniques to achieve greater institutional congruence with the new conditions was another aspect of restructuring observed for firms in this study. Changing to production methods compatible with the needs of the global market benefits firms by requiring them to develop new technical standards and expertise. A common technique observed in the case study firms was altering production so that individual workers deal with a number of tasks, and consequently approach production from a more holistic perspective. In some respects this is only a minor change, for the system carried forward from Communist-era production where “workers are in teams that work on the orders and functions in teams change with different orders” (Drazitest 7, Personnel Manager) mirrors the semi-autonomous

workgroups of post-Fordist production techniques. However, in developed market economies it is an adaptation designed to humanise working practices, whereas the centrally planned economy demanded such flexibility to overcome the shortages and irrationalities of planning. Restructuring production can raise problems though if the changes are not relevant to production conditions, with an instance of this leading to one worker complaining that

not all the changes made are good. Workers on the assembly line know what is good but problems come when “technologists” try to make changes but have never tried to work with them (Přesnost KM 3, Assembly line worker).

Changes that enable the firm to become more economically viable are necessary, but the management must be aware of the embeddedness of existing production systems and the skills and capabilities of their workforce if these are to be successful. With the move towards a market economic system, there are exogenous institutional processes that demand restructuring within the firm. With the move from producer to consumer-driven production, firms have to restructure their product lines in response to aggregate demand. An important institutional change that can help achieve this and that impacts on the internal structure of firms has come from the need to increase the quality of production, symbolised by the adoption in each of the companies in this study of the appropriate ISO 9000 series norms or equivalent industry standards to ensure quantifiably high standards are consistently achieved.⁷⁰ For this to produce the effective restructuring changes desired by managers though, it is crucial that

⁷⁰ Grayson and Bodily, *Integration into the World Economy*, [n.p.]; Lubomír Lízal, *Does a Soft Macroeconomic Environment Induce Restructuring on the Microeconomic Level During the Transition Period? Evidence from Investment Behaviour of Czech Enterprises*, Working Paper, 235 (Ann Arbor: Davidson Institute, 1999), p. 3.

employees recognise their significance. Evidence of this occurring clearly elucidated by one respondent who commented on how production differs now compared to the Communist past

where there were plans for producing large numbers. Now customers each have their own demands and these have to be fulfilled individually, for example on colour, equipment, etc (Rozdat Systems 6, Supervisor).

Another manager commented on this, stating that

as a state-owned enterprise, priority was to complete the plan and it did not matter if it made sense or not, but we just had to do it. Now it depends on the board, if they are satisfied with the work done, if orders are completed on time, and if the work done is of a high standard (Drazitest 6, Business Director).

For some other companies, improvements in production quality have come from economically necessary rationalisation of production in the post-privatisation era. For example, whilst

historically Rukopis Strojírny has also made other products, now we are looking to leave these other activities and to concentrate on one product line and in particular the service, sales, quality, and manufacture of these alone (Rukopis Strojírny 2, Operations Director).

Positive benefits of such a strategy have been realised in Brodchmel where favourable market conditions have subsequently led to the company considering expansionary techniques to ensure its future survival and development. Here

before privatisation, production was concentrated on three products in three plants for production. After privatisation two were shut down as the customers were insolvent, but now with time the company is trying to diversify production again and create and find new products to concentrate on (Brodchmel 1, Personnel Manager).

Another institutional change promoting restructuring is economic liberalisation and new opportunities for co-operation with foreign partners that results in quality improvements. This has already been realised in Odras KM, where products are being developed for German and Swiss companies (Odras KM 1, Managing Director). This is seen to be of particular importance because in

working with foreign companies that have not been under socialism, we must work well for these. We have to do what they want in a short time and for this there needs to be new computers, new programmes for design, working in accordance with what the customers want (Odras KM 3, Technical Designer).

There are long-term gains from this, for “although in initial dealings we were not at the same status, we have since achieved an equality with them” (Odras KM 1, Managing Director). The end of the CMEA, alongside trade liberalisation, have been important institutional changes because they offer new opportunities for

improvements in product development and technological transfers. The benefits respondents saw from this was that

all our products are at the right level of quality as we have used the opening of markets and can now buy the best products. We now have the same conditions in using know-how and developments in technology as our business partners and competitors and have our own unique components of a very high quality designed in direct collaboration with a large multinational firm (Rozdat Systems 4, Technical Director).

Trade liberalisation also removes the artificial comparative advantage established for production within the CMEA, which has enabled Císař to

return to its traditional production. When IT production started, all the traditional production activities were reduced. Before 1989 around 90% of production was in IT but this had to stop after 1989 as majority of exports had been to CMEA markets. The technology was one generation behind the West and therefore production ceased after the changes as cheaper and higher quality products were available from the West (Císař 1, Trade Union President).

Other firms have introduced changes motivated by the altered institutional environment as illustrated for Drazitest where

although much of the work still remains, there is no need to do that which was previously “work for no reason but to keep some employed” (Drazitest 1, Quality Director).

Similarly in Přesnost KM

now we produce fewer products than previously. When the CMEA broke apart, these markets were lost and we had a huge decrease in production of the classic product line selection although there have been compensations elsewhere (Přesnost KM 1, Financial Planning Manager).

These shifts in the operating environment of firms then permit managers to implement appropriate restructuring measures that are regarded as economically beneficial, but that cannot be introduced without these changes firstly being made.

The corollary of economic liberalisation is that it has also brought difficulties to firms and can hinder restructuring changes as in Drazitest where although

the main goal of Drazitest is prosperity and aiming to expand activities in the professional area by offering more services and improving regional involvement with expansion into other regions both in the Czech Republic and abroad, problems of expansion apply to everywhere, not just in going abroad. A loss of markets through political change is part of the problem and is difficult to get new territories, whether expansion into foreign markets is either independent or

by using a foreign company as a strategic partner (Drazitest 7, Personnel Manager).

Access to appropriate markets is a problem for Rozdat Systems, having limited export possibilities because “the main external market is Eastern Europe” (Rozdat Systems 1, Managing Director). Although it was stressed that “there is a large market potential in China and South America” (Rozdat Systems 5, Financial Director), significant expansion into high income markets is restricted, for

newer markets are Iran, Pakistan, but there is nothing really in Western markets, except a little in Austria as competition is strong and these markets are already quite saturated in the West (Rozdat Systems 4, Technical Director).

Competitive pressures are extremely strong and hard to overcome for these firms, for whilst they seek foreign assistance because they recognise limitations in their own production techniques and

would therefore like to see some help from outside, when foreign firms find out we are from Brodchmel, they do not let us learn because they fear the competition and therefore there is no way we can learn about managing from foreign competition. It is almost impossible to learn from Western companies because of competition and we therefore cannot reach effectiveness of foreign companies (Brodchmel 4, Quality Manager).

The second significant type of production change is for a firm to become involved in co-operation and sub-contracting to foreign firms. This has been adopted in Přesnost KM “in an attempt to find sources of cash flow because of the collapse of previous markets in the East” (Přesnost KM 2, Co-operation Plant Section Head). For the firm, this is “the biggest change since 1990 and is something completely new” (Přesnost KM 1, Financial Planning Manager), but has been beneficial to overall quality. The head of one of these production areas claimed

this part is challenging European standards because the company co-operates in Japanese markets and the parent is based in the USA and so has to prove itself here (Přesnost KM 2, Plant Co-operation Section Head).

Co-operation production may be their only potential survival strategy in the short-term, but although it protects employment even if this is at the cost of deskilling of some of the workforce, it can also be regarded as a form of subordination of the newly emerging countries of Central and Eastern Europe to existing producers.⁷¹ Managers can therefore be unwilling to adopt this if it threatens their personal authority within the firm, but it can be very effective at initiating restructuring changes within firms.

A final aspect of production changes that constitute a restructuring change in enterprises has arisen because of the changed function of employment. With central planning, enterprises were the primary domain of social assistance to employees and

⁷¹ Jan Vláčil, ‘Economic, Organizational and Personnel Problems in the Manufacturing Firms, in *Politics, Skills and Industrial Restructuring*, Institute of Sociology Working Paper, 8, edited by J. Vláčil, I. Hradecká, I. Mazálková and G. McDermott (Prague: Academy of Sciences of the Czech Republic, 1996), pp. 43-48, p. 44.

their families, and so had large overheads from social provision.⁷² As political justifications for this social function of enterprises and work has been lost with the move to capitalism, many firms have simply ceased operating in these areas. This was demonstrated in Přesnost KM where

in 1993 the firm was in a critical financial situation and a programme to improve the “health” of the company was realised. The firm sold shares that had been retained to gain finance for restructuring and sold off unnecessary assets, housing, supplies, etc., and overcame the financial problems by lowering the basic fixed costs of the company (Přesnost KM 1, Financial Planning Manager).

Now in Rukopis Strojírny there are “outside contracts to companies for the parts that cannot be made on site” (Rukopis Strojírny 1, Personnel Manager) and “several other smaller companies to look after catering, housing maintenance etc” (Rukopis Strojírny 2, Operations Director). Comparable changes occurred in Drazitest, where “restructuring was needed because the firm had to start competing and there is a lot of competition in the market” (Drazitest 4, Researcher), so

1/5 of the state-owned enterprise remained for this company that is the core of the Drazitest state-owned enterprise and the extra structures that were not needed were got rid of (Drazitest 3, Supplies Manager).

⁷² Anna Soulsby and Ed Clark, ‘Privatisation and the Restructuring of Enterprise Social and Welfare Assets in the Czech Republic’, *Industrial Relations Journal*, 26 (1995), 97-109, pp. 97-98.

As a result, privatised firms are becoming more highly focused on their main production areas, representing a favourable development from the perspective of enterprise restructuring.

As demonstrated by the responses given, the firms in this study show a strong tendency towards restructuring according to economic considerations borne out of a need for survival of the firm. However, the structural organisation of the firm and patterns of authority also provide an institutional framework within which all of the above changes operate, and in part define their effectiveness, as discussed in this final section.

5.3.5 Organisational Changes.

Although many former state-owned enterprises had a wide skill and product base that provides flexibility in transformation at the enterprise level,⁷³ this can cause them to be overdiversified in an environment that primarily values economic efficiency.⁷⁴ This can be as risky as too narrow a specialisation for overall stability,⁷⁵ but the potential for refocusing onto core business activities to bring about an increase in the marginal value of resource use, market value, and higher profit comes from improved

⁷³ Gerald A. McDermott, 'Governance Structures and Restructuring in Machinery Firms, in *Politics, Skills and Industrial Restructuring*, Institute of Sociology Working Paper, 8, edited by J. Vlášil, I. Hradecká, I. Mazálková and G. McDermott (Prague: Academy of Sciences of the Czech Republic, 1996), pp. 31-42, p. 32.

⁷⁴ Edward J. Green, 'Privatisation, the Entrepreneurial Sector and Growth in Post-Comecon Economies', *Journal of Comparative Economics*, 17 (1993), 407-417, p. 413; Miklós Szanyi, 'Ownership Change and Performance in Companies in the Former Socialist Countries of Europe', in *Changes and Challenges: Economic Transformation in East-Central Europe* edited by Pál Gáspár (Budapest: Akadémiai Kiadó, 1995), pp. 119-131, p. 124.

⁷⁵ Heather Haveman, 'Between a Rock and a Hard Place: Organizational Change and Performance Under Conditions of Fundamental Economic Transformation', *Administrative Science Quarterly*, 37

managerial control over the firm.⁷⁶ Nonetheless, this does not simply require internal production changes, but should also be complemented with structural changes to the overall configuration of the firm.

Upstream and downstream production were formally internalised in plants to ensure supplies because of uncertainty under central planning, but this needs to cease now as

each factory in the machine industry had many fields of production making different products. Nowadays the market asks for lower expenses and higher quality. For this it is better to have smaller companies that specialise in one kind of product manufacture (Brodchmel 4, Quality Manager).

As state-owned enterprises were often involved in periphery production and other activities, spin-offs can be a viable structural change to rationalise production and the composite structure of the firm after privatisation.⁷⁷ Defined broadly as the division of an existing company into a parent and the (usually smaller) spin-off or daughter company, these can occur in two ways. The first is a restructuring response where the creation of a new firm comes from strategic motivations in the pursuit of overall efficiency for the new firm and sometimes also the parent. The alternative is an entrepreneurial response, where a new firm is established with existing employees using experience gained from their work in the parent on a new product or market

(1992), 48-75, p. 53; Edward H. Bowman and Harber Singh, 'Corporate Restructuring: Reconfiguring the Firm', *Strategic Management Journal*, 14 (Summer Special Issue) (1993), 5-14, p. 6.

⁷⁶ Constantinos C. Markides, 'Consequences of Corporate Refocusing: Ex Ante Evidence', *Academy of Management Journal*, 35 (1992), 398-412, pp. 398-400; Richard A. Johnson, 'Antecedents and Outcomes of Corporate Refocusing', *Journal of Management*, 22 (1996), 439-483, pp. 441-442.

⁷⁷ Soulsby and Clark, 'Privatisation and the Restructuring', p. 103.

niche.⁷⁸ This latter type can also take the form of a new start-up rather than a spin-off if resources are not provided directly by the parent company. As shown in companies in this study, both restructuring and entrepreneurial driven responses are occurring in Czech enterprises. The privatisation legislation provided a framework to support both processes because numerous forms of privatisation could be proposed for asset divestitures and transfers, with the choice between these driven by access to information and resources in the early privatisation period.⁷⁹ A third possibility that could be especially prominent in post-communist countries in particular is that spin-offs could be driven by an employee's desire for increased power and personal welfare as a manager of a new firm, rather than seeking improved performance within their existing firm and position.⁸⁰ Although difficult to ascertain the extent to which this is a motive behind change, in Císař this was alluded to by one respondent commenting that

although privatisation came from the law, the management also found it attractive to be an independent company; they knew that the company had to be restructured and they liked it this way too (Císař 1, Trade Union President).

The restructuring motivation led to Rozdat Systems being spun-off as a daughter company of Rukopis Strojírny because a foreign firm expressed an interest in buying this part (Rozdat Systems 1, Managing Director), but this has generated "problems

⁷⁸ Alexander Tübke, *Corporate-Spin-Offs.com*. 16 November 2000. <<http://www.corporate-spin-offs.com>>, [n.p.].

⁷⁹ Judith Sedaitis, 'The Alliances of Spin-offs Versus Start-ups: Social Ties in the Genesis of Post-Soviet Alliances', *Organization Science*, 9 (1998), 368-381, pp. 375-376.

⁸⁰ Lubomir Lízal, Miroslav Singer and Jan Švenjar, *Manager Interests, Breakups and Performance of State Enterprises in Transition*, Working Paper, 51 (Prague: CERGE, 1994), p. 22.

with Rukopis Strojírny as the owner” (Rozdat Systems 6, Supervisor). Also in Odraz KM, a second daughter company of Rukopis Strojírny that was similarly spun-off

there is a lot of relationship strain with Rukopis Strojírny now because previously about 56% of production was for them but this did not give stability because of uncertainty over delivery of materials and money. From 1997, Odraz KM has been looking at revising the company’s development to change from mainly supplying Rukopis Strojírny and to looking for more co-operation with foreign companies and to increase annual turnover (Odraz KM 1, Managing Director).

Such conflicts between the management and owners that are consistently left unresolved demonstrate that principal-agent problems have not been overcome with this change. The extent of authority that managers have can be unclear, but often the owners lack credible constraints to ensure that their interests are represented. This has not prevented restructuring where the managers have then been able to exercise *de facto* control. In evidence, respondents in these daughter companies placed greater emphasis on subsequent internal changes than on the structural changes that had led to their creation. In Rozdat Systems, it was claimed that the

structure of the firm has been developing for many years and is now optimal, which is one of the reasons that Rukopis Strojírny is now making structural changes to mirror these (Rozdat Systems 5, Financial Director).

Restructuring and subsequent changes can be seen, since the company was

previously a typical state-owned enterprise, only able to use Eastern know-how.

Now the structure is very different compared to pre-1989 where the main production was for the state, which ended in 1994, and only the development of new services from 1990 in this product line saved production here (Rozdat Systems 4, Technical Director).

In Odraz KM, changes have occurred because of exogenous pressures so “1993 saw the closure of the foundry because of environmental pressures” (Odraz KM 1, Managing Director) and “moving into smaller buildings to make the company smaller and reduce costs” (Odraz KM 3, Technical Designer).

Comparable structural changes were made in Císař following privatisation

as smaller companies are more flexible as far as changes in financing and structure. In 1992 the state-owned enterprise was changed into a joint-stock company, and a new structure of daughter companies came into existence in 2000. The economic situation is more transparent and they are independent in all areas e.g. financially, economically, and politically as the daughter companies wanted, which was their main goal in making these independent companies. The change in structure was initiated by the owner, presented to and agreed by shareholders at the AGM. Its structure is now a holding company with five divisions, and four wholly-owned daughter companies (Císař 4, Services Director).

Benefits amongst employees were anticipated from this since

the new daughter companies came from the different production sections, so it is hoped this decentralisation will be better as the management in the daughter companies are closer to the problems and know the problems there. How much independence these have is unclear as this has just started but communication is better as the problems are solved immediately at the place where these occur (Císař 2, Machine worker).

However, the strategy has been criticised by others in the firm who feel that the strategy is not warranted, because there are

some parts that the management has paid too much attention to, even if this was not justifiable or necessary but they did not want to accept that this was taking the whole company down and would not get rid of it even though if doing this would make the whole company healthier. Císař is a mother company with four daughter companies and the management should pay the same amount of attention to all the parts and then these should bring the same amount of profit to the market. The problem has been that the daughter company with the lowest profit has been accepted as the area of its highest priority (Císař 3, Retired Analyst).

Another aspect of the strategy that was criticised was where the management seemed to pursue the profit goal with inadequate consideration of the consequences of this.

One respondent described how they

joined some parts of production into one complex under one management, moved machines into new locations, and reduced the size of machinery as the management wanted to make production cheaper, but employees now complain that they do not have some of the technology necessary to make some products, so only time will tell if the changes have worked (Císař 1, Trade Union President).

It therefore appears to the employees that managers have acted to maximise their own pecuniary interests, but that this has been detrimental overall to the firm's restructuring and survival after privatisation. Whilst in theory the economic logic behind such decisions is clear, in Císař it appears that there are non-economic motives underlying much of the restructuring strategy of the owners and managers in what is increasingly a failing firm.

An entrepreneurial type response motivated the restructuring that occurred for some parts of Drazitest following the dissolution of the former state-owned enterprise. Following privatisation, Drazitest is all that remains of the original parent, but two other firms were created by employees purchasing assets in the small-scale privatisation programme from the old divisions of the Drazitest state-owned enterprise to establish new, independent companies. Both of these have successfully redefined their role within this market area, although relationships between them and Drazitest are retained to some extent. Here also the prestige motivation may have been significant in the establishment of each of the new plants out of the former divisions, but it is not explicitly definable, and the parts not privatised by voucher are not considered further in this work. However, the entrepreneurial response is less likely

to occur with voucher privatisation because of the larger or uneconomic nature of the assets included in the programme that precluded outright sales to strategic investors.

An alternative structural adaptation has been the decentralisation of decision making and devolving responsibility down the corporate hierarchy to encourage efficiency improvements. Divisionalised firms (M-firms) are divided into distinct production units, with senior managers only concerned with strategic decisions, allowing localised management tasks to be dealt with at or near the point of production. This contrasts with unitary firms (U-firm) where top managers are additionally responsible for taking decisions regarding co-ordination between functional units.⁸¹

For restructuring state-owned enterprises, divisionalisation can offer a number of benefits. Firstly, as a structure distinguishable from that of enterprises in centrally planned economies it represents a decisive change in the structure of firms associated with the new economic system. Secondly, this can be understood as the “optimal” form of structural organisation to be attained because its prevalence in Western companies provides a benchmark against which to measure the extent of structural change in an otherwise highly uncertain environment. Appealing to the credibility of models already operating in other market economies, especially with regards changing the structural form of enterprises away from their hierarchical form that was consistent with central management of the economy into more decentralised decision-making structures may be undertaken to try to break associations and links to the former system. Divisionalisation can help break the prevailing monopolistic orientation of firms and introduce market-oriented intra-departmental relationships

that were neglected under the former system. It can also allow management to reassert control over the labour force at every level within the enterprise, especially by redefining structures of power and influence to bring a consolidation of their own power.⁸² As U-firms expand, strategic decision-making becomes more difficult for top managers to administer because of the range of tasks that needs to be covered. In response, M-firms are often preferred in market economies because relevant decision-making is devolved to specific task areas, and the top management only needs to be concerned with overall strategic decisions.⁸³ This motive for divisionalisation is liable to be strong as there are new functions that need to be undertaken within production units. Previously only certain firms were allowed to participate in foreign trade, and this only in co-operation with specific state-run foreign trade units. With the collapse of the CMEA markets and trade liberalisation, exports potentially presented new market opportunities globally. Marketing divisions did not exist in state-owned enterprises as they operated under production-led conditions, with state distribution channels for their output. Now firms have to establish these, “which is one of the biggest changes” (Rozdat Systems 4, Technical Director), for this was previously a function external to the firm as described for Brodchmel where

until privatisation an organisation in Prague was marketing these products, but after privatisation a new marketing department had to be created (Brodchmel 3, Assembly Section Head).

⁸¹ Donald Palmer, Roger Freidland, P. Devereaux Jennings and Melanie E. Pavers, ‘The Economics and Politics of Structure: The Multidivisional Form and the Large US Corporation’, *Administrative Science Quarterly*, 32 (1987), 25-48, p. 25.

⁸² Grosfeld and Roland, *Defensive and Strategic Restructuring*, p. 18; Ed Clark, ‘Czech Enterprises and the Multidivisional Form: Legitimation, Legacies and Structural Choice’, *Journal for East European Management Studies*, 3 (1998), 46-63, pp. 47, 54.

In Rukopis Strojírny, several respondents commented on the trend towards divisionalisation, so that now “each part has its own directors who are responsible for their own divisions e.g. economics, technology” (Rukopis Strojírny 1, Personnel Director). The process comprised

changes both large and small. Major changes to the structure have occurred three times, with the introduction of separate export and import sections (Rukopis Strojírny 1, Personnel Manager).

Alongside these changes, there has also been the

creation of a sales department, as previously the company did not sell independently. Until 1990 sales were through state companies specialising in this (Rukopis Strojírny 2, Operations Director).

Similar changes occurred in Rozdat Systems where divisionalisation

began in 1993 with demands from the market. One of the biggest changes was the need to found business centres or trade departments and sales departments (Rozdat Systems 4, Technical Director).

Also in Přesnost KM “in 1990, management began looking at ways the company is run and out of this came 20 divisions, but now about 4 divisions run the company” (Přesnost KM, Financial Planning Manager). An important aspect of such

⁸³ Palmer *et al.*, ‘Economics and Politics of Structure’, pp. 25-27.

divisionalisation is that it alters the interconnections between departments and incentives for production. This was demonstrated in one firm where

the main change was the split from the Drazitest state-owned enterprise and division into "professional sector branches". Now every branch has its own executive director to organise work, and each section should have assessors to guarantee work and quality. This did not exist before 1989 when all were under one directorship that had all the responsibility as it was not necessary to do any searching for contracts since the state gave work and this just had to be divided amongst workers at the lower levels. Now each branch has to do this and also look for work and bargain over prices (Drazitest 1, Quality Director).

Comparable adaptations were seen in other firms, as in Brodchmel, where structural changes occurred with the

conversion from a state-owned enterprise, with a lowering of the number of employees, and an amalgamation of all the departments not involved in production, and then all the production departments respectively (Brodchmel 1, Personnel Manager)

In Rozdat Systems also this was seen, where

the main change has been moving the supply department from being part of the sales department and combining it now with production. In the future, further integration of activities is expected with the technical department to be

combined with production as there is a need to simplify connections between the departments (Rozdat Systems 4, Technical Director).

These responses indicate that divisionalisation is more than a structural change but involves shifts in the balance of power within enterprises that favour the management and enables it to exercise authority over strategic and operating level decisions within the firm. As the legal position of managers is weaker than that gained informally following privatisation, it is unsurprising that the M-form firm has been favoured by them as this helps consolidate their authority.

Problems can arise though because the M-form is accompanied by changes in control and power-relations within a company.⁸⁴ As described for Odraz KM

after privatisation some things had to be done that were not done before such as dealing with banks and building distribution networks. The problem was that most people at Odraz KM were not prepared for this, and since the change was very sudden there were a lot of personnel changes in the company and instability because of this. However, Odraz KM overcame this instability faster than Rukopis Strojírny by being smaller and more flexible (Odraz KM 1, Managing Director).

The effectiveness of any change is therefore shown again to be dependent on the institutional environment and pressures and constraints on managers to introduce

⁸⁴ Clark, 'Czech Enterprises and the Multidivisional Form', p. 55.

changes and to see them become successfully embedded into the operation of their firms.

5.4 CONCLUSION.

Voucher privatisation has resulted in dispersed ownership and weak corporate governance mechanisms, so managers often achieve *de facto* control over their enterprises. This makes their actions instrumental in determining the extent and effectiveness of restructuring changes. The institutional context of privatisation creates this outcome, but managers are themselves constrained in their activity by the existence of institutions that encourage or preclude change that determines the restructuring that occurs. Managers acting rationally will try and meet their own interests, and these do not have to correspond to those of the firm's owners, but can still incorporate favourable restructuring developments.

Changes to the internal and external structure of former state-owned enterprises are essential for their long-term existence, given the altered external operating environment for these firms arising from the transformation.⁸⁵ Privatisation is a catalyst to restructuring that is externally imposed and this will only impact comprehensively on restructuring of former state-owned enterprises if it brings about the removal or changing of attitudes amongst the top managers and elites, who are often those most resistant to change within enterprises.⁸⁶ In all firms privatised by

⁸⁵ Jan Mládek, 'Czech Companies after the First Wave of Voucher Privatisation: Was the Change Real or Formal?', in *Privatisation in Visegrád Countries: Old Principles and New Methods*, edited by Miklós Szanyi, Proceedings of the International Conference (Budapest: Institute for World Economics, 1994), pp. 153-172, p. 172.

⁸⁶ Saba, 'Orphans in the Storm', p. 121.

voucher in the Czech Republic some form of restructuring occurred through designing a privatisation projects, which represents their having undertaken a strategic management task. Changes in workplace practices, the firm's structure and culture, and new and re-oriented investment strategies as aspects of deep restructuring are also required, but restructuring changes may not be effectively implemented if their purpose is not understood properly by those introducing and adapting to these changes.⁸⁷ The newly privatised firms have a low capacity to adapt to change, and limited relevant experience from their previous operation that can be used in their new operating environment.⁸⁸

There are a number of potentially conflicting issues that can affect the nature and form of restructuring that can occur in a firm. A successful strategy has to encompass "soft" and "hard" issues. Quantifiable changes in production techniques and shifts in product mix, quality improvements, efficiency improvements in resource use, and forward-looking investment strategies are important. However, qualitative features such as marketing, managerial styles, changes in organisational structure, human resource management, and effective corporate governance can also be definitive for successful or failed restructuring.⁸⁹ Skills and experience rewarded within the centrally planned economy were those effectively adapted to these conditions. Limited institutional change encourages the persistence of old behavioural patterns

⁸⁷ Philippe Aghion and Wendy Carlin, 'Restructuring Outcomes and the Evolution of Ownership Patterns in Central and Eastern Europe', in *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*, edited by Salvatore Zecchini (Dordrecht: Kluwer Academic/OECD, 1997), pp. 241-261, pp. 244-245.

⁸⁸ Karen L. Newman, 'Organizational Transformation During Institutional Upheaval', *Academy of Management Review*, 25 (2000), 602-619, pp. 605, 606, 612.

⁸⁹ Josef C. Brada, *Management 101: Behavior of Firms in Transition Economies*, Working Paper, 133 (Ann Arbor: Davidson Institute, 1998), [n.p].

amongst managers,⁹⁰ in direct contradiction with the aims of privatisation to bring external pressures from owners that would force the adoption of market-oriented behaviour.⁹¹ Managers are faced with the dilemma of undertaking change with uncertain benefits in the future, or maintaining the *status quo* but with costs in the future.⁹² If they perceive that change is most likely to reduce their status and power and they fear losing their job in the uncertain economic environment, little change is likely to occur. Although a natural tendency may be for actors within organisations to revert to behavioural patterns that have historically proved successful, in the transformation to a market economic system some of this behaviour may be so dysfunctional as to hinder the organisations ability to adapt, so it is important to ensure that deep and lasting changes occur to prevent this.⁹³

Important constraints on change for managers are limited experience and finance, which can permit only superficial restructuring to occur.⁹⁴ Many of the restructuring changes introduced are those normally regarded as the domain of owners in firms in developed market economies. As credible owners are often lacking in voucher privatised firms, managers instead try to use this vacuum of power to implement changes that will enhance their position. This further consolidates the importance of managers having *de facto* control within enterprises, even if this is not supported by *de jure* shareholdings. Throughout this chapter it has been demonstrated that the ability of managers to implement these changes and their effectiveness is dependant

⁹⁰ Dinko Dubravčić 'Entrepreneurial Aspects of Privatisation in Transition Economies', *Europe-Asia Studies*, 47 (1995), 305-316, p. 310; Whitley *et al*, 'Continuity and Change', p. 234.

⁹¹ Clark and Soulsby, 'Organization-Community Embeddedness', p. 29.

⁹² Wendy Carlin, John van Reenen and Toby Wolfe, *Enterprise Restructuring in the Transition: An Analytical Survey of the Case Study Evidence from Central and Eastern Europe*, Working Paper, 14 (London: EBRD, 1994), p. 8.

⁹³ Peter Murrell, 'Privatization Complicates the Fresh Start', *Orbis*, 36 (3) (1992). Academic Search Elite. EBSCO Publishing. 24 April 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

⁹⁴ Myant, 'Transformation of Czech Enterprises', p. 155.

upon the context within which they are introduced. The role of labour has been touched upon briefly but this is an important institutional influence on restructuring in its own right. It impacts on the effectiveness of managers, and also owners to some extent, in being able to implement restructuring measures because it is the primary mechanism through which change within enterprises is effected. The following chapter therefore considers developments in labour market conditions and wider institutional framework of industrial relations. This deepens and complements this discussion of post-privatisation enterprise restructuring in former state-owned enterprises in the Czech Republic by addressing the question of institutional limitations to effective restructuring at the level of the workforce within enterprises.

CHAPTER SIX

LABOUR MARKETS AND INDUSTRIAL RELATIONS

The two preceding chapters have demonstrated the significance of owners and managers as institutional influences to understanding the observed restructuring in formerly state-owned Czech firms. Having argued that *de facto* control is generally a more important determinant of restructuring than *de jure* ownership, this chapter contends that the actual influence of the post-privatisation restructuring measures of both owners and managers depends on the labour resource. Labour markets and the industrial relation structures provide formal and informal institutional influences on the restructuring measures introduced, but also directly affect the incentives of labour to adapt to these once they have been introduced.

The chapter argues that assessing restructuring within enterprises cannot be achieved unless the context at the enterprise level where the desired changes are implemented is understood. The discussion of labour markets and the industrial relations framework as institutional influences again demonstrates the importance of an approach such as embedded institutionalism that can account for the comprehensive range of institutional influences on restructuring within firms. Whether owners and managers can overcome formal and informal legacies that dictate how labour responds to the new working practices is vital to effective post-privatisation restructuring within firms.¹ Nonetheless,

¹ Jiří Buriánek, 'The Industrial Relations Still in Transition: A Commentary on Some Recent Studies on the Czech Case', *Journal for East European Management Studies*, 2 (1997), 161-172, p. 167.

labour is also subject to the influence of these institutions, and so this chapter shows that overall the interaction of these institutions gives labour a direct, although limited, impact on restructuring outcomes in enterprises. A new institutional environment is emerging, but the period of central planning still shapes the expectations and responses of labour over work. Although owners and managers conceive formal restructuring strategies after privatisation, employees achieve and exercise *de facto* control by dictating how these changes are incorporated into the operation of the firm. Also, the industrial relations framework in existence that prescribes legal requirements for owners and managers to abide by, and so determines the feasible range of restructuring measures that can be introduced, also affects the incentive structure of workers to adapt to these changes. The purpose of this chapter is therefore to complement the preceding discussion of incentives for owners and managers to undertake restructuring by considering how labour responds to and implements their desired restructuring measures.

The size of the labour force in state-owned enterprises was artificially inflated as Communist governments desired full employment for socio-political reasons, although this was economically inefficient. Changes in unemployment levels with the transformation are reviewed here because these can indicate whether restructuring and therefore necessary labour shedding is occurring in firms. Factors that determine these aggregate levels are discussed, but it is shown that restructuring does not always correspond with higher unemployment in the economy, making these levels alone insufficient as an indicator of change. An important determinant of unemployment levels that is also an institutional influence on the choices labour makes about unemployment

derives from the structure of unemployment policies. Their evolution and the potential effects of this on restructuring outcomes are discussed in section 6.2. As these influences do not give a prediction of how unemployment affects restructuring outcomes, this section is followed by a discussion of labour productivity in the case study enterprises. This shows that institutional influences hinder improvements, and therefore limit the effectiveness of restructuring in these firms.

In addition to unemployment issues, the formal institutional framework of industrial relations affects the responses of labour to the restructuring strategies of owners and managers. It is shown in particular that trade unions have a declining influence in privatised firms as the transformation continues. The patterns of employment since 1989 also depend upon wage policies, which in turn influence restructuring decisions by altering the demand and supply of labour in privatised firms. In the chapter, each of the above aspects are discussed, with the theoretical projections supplemented by empirical data from the case studies to demonstrate how these interact and are resolved at the enterprise level.

Labour shedding is required in many former state-owned enterprises after privatisation, but labour markets need to operate effectively if structural changes in enterprises are to arise from this. The cases in this study provide evidence of continual labour shedding so that within firms it is expected that “more unemployment is inevitable, but we cannot tell where and how much is likely to occur” (Rukopis Strojírny 6, Machine worker).

Unemployment levels in transforming economies are subject to many contradictory institutional influences. The general institutional context of unemployment levels is therefore presented before turning to consider the impact of unemployment policies as a specific institutional influence that helps determine these levels, as the actual restructuring outcomes in firms in response to these can only be resolved empirically.

6.1 UNEMPLOYMENT AND RESTRUCTURING.

Holding a job became an institutionalised “right” under socialism, with unemployment rejected as a failing of capitalism, and those not working without legitimate reason liable to imprisonment. Full employment was initially the consequence of extensive growth policies, but despite the social stability and personal benefits to individual employees, it engenders inefficiency in production, and promotes a culture of “work avoidance”.²

Unemployment becomes visible in transformational economies since full employment can no longer be ideologically justified at the cost of economic inefficiency. Despite its costs, respondents recognised that this change would occur since “previously unemployment did not exist, which was abnormal” (Císař 3, Retired Analyst).

The KSC had the right to directly allocate labour resources, although rigid planning could not be applied to labour as with other resources in the economy since labour can be

² Milford Bateman, ‘Introduction: The Transition Towards the Market Economy’, in *Business Cultures in Central and Eastern Europe*, edited by Milford Bateman (Oxford: Butterworth Heinemann, 1997), xiii-xxii, p. xviii.

differentiated and motivated with the correct incentives to increase its value.³ Policies were formulated to either directly or indirectly affect existing and planned labour demand and supply, with labour resources deployed to meet the economic and social needs of the country, including full employment.⁴ In the post-communist era, labour may be unwilling to see this revoked despite its incongruence with the economic rationale of the new system. Having not been a feature of the centrally planned economy, the response of enterprises to open unemployment is essential to understanding post-privatisation restructuring in Czech firms. As one respondent commented, persistent mentalities can prevent workers adapting to the economic need for unemployment because

the previous system supported workers in a strong way, but now with capitalism this does not exist as there are no special workers rights and the state does not support them as much as before, but they cannot wake up from this change (Brodchmel 4, Quality Manager).

A distinguishing feature of the Czech transformation in comparison with other transforming economies of Central and Eastern Europe has been its low levels of unemployment, despite apparent restructuring in former state-owned enterprises.⁵ It is essential to determine whether the country's historical legacies and its initial starting conditions pre-determined this outcome, giving Czech firms an advantage as

³ Alec Nove, *The Socialist Economic System*, 3rd edition (Winchester, MA.: Allen and Unwin, 1986), p. 202.

⁴ Jan Adam, *Employment and Wage Policies in Poland, Czechoslovakia and Hungary Since 1950* (London: Macmillan, 1984), pp. 3, 43, 45-46, 49, 105, 108, 109.

transformation progresses, or if higher unemployment is inevitable as enterprises subsequently undertake restructuring not motivated by survival. If the latter, then privatisation alone generates insufficient impetus for rationalisation of labour use in enterprises. The following section describes features of Czech unemployment that are structurally derived, for these are important to supporting favourable developments in the transformation, and show how unemployment does not have to correlate with restructuring within enterprises.

6.1.1 Low Unemployment – Miracle or Mirage?

By international standards, low unemployment levels have characterised transformation in the Czech Republic.⁶ Three waves of unemployment can be discerned since 1989, with two periods of low, or only slowly increasing, unemployment between 1989 and 1991, and 1992 and 1996, followed by more rapid increases since 1996. Peaking in 1991 at 4.1% of the labour force, annual unemployment levels did not then exceed 5% for another six years,⁷ although the subsequent progressive rise in unemployment may be indicative of the start of a second distinct phase in unemployment. Whilst too little time has elapsed to determine whether this will represent a long-term trend, the Czech

⁵ Robert J. Gitter and Markus Scheuer, 'Low Unemployment in the Czech Republic: "Miracle" or "Mirage"?', *Monthly Labor Review*, 121 (8) (1998), 31-37. Business Source Premier. EBSCO Publishing. 17 June 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

⁶ Daniel Daianu, 'Judging Romania's Way in a Comparative Framework', in *Economic Developments and Reforms in Cooperation Partner Countries: The Social and Human Dimension*, edited by Reiner Weichardt (Brussels: NATO Economic Directorate and Office of Information, 1997), pp. 241-260, p. 249.

⁷ In part, there is a statistical gain for the Czech Republic after the split of Czechoslovakia, as Slovakia has had consistently higher unemployment of a more long-term, structural nature. CCET/OECD, *Industry in*

Republic still maintains unemployment levels consistently lower than other transforming economies of Central and Eastern Europe.⁸ However, these levels alone are not an accurate indication of whether privatisation is associated with enterprise restructuring.

Observed unemployment levels reflect the interaction of a number of different institutions that are complex and may be contradictory in their effects.⁹ These different institutions are not only institutional influences on the levels of unemployment, but they also act to shape the expectations and responses of labour in transformation and, as a result, the *de facto* control labour achieves over enterprise restructuring. This section considers institutional influences that have contributed to levels of unemployment in the transformation aside from lay-offs as a strategy of enterprise restructuring.

Some initial conditions positively limited unemployment levels in Czechoslovakia. Immediately after transformation began, Klaus undertook two measures to enhance the competitiveness of the domestic industry: a currency devaluation from Kč 14/US\$ to Kč 28/US\$, and a reduction in real wages of over 40%.¹⁰ This did not preclude unemployment, but in combination with the country's favourable fiscal position, did

the Czech and Slovak Republics (Paris: OECD, 1994), p. 29; Domenico Mario Nuti, 'Fighting Unemployment in Transitional Economies', *Most-Most*, 6 (1996), 39-55, p. 48.

⁸ OECD, *Economic Survey: Czech Republic 1997-1998* (Paris: OECD, 1998), p. 77.

⁹ Tito Boeri, 'Heterogeneous Workers, Economic Transformation and the Stagnancy of Transitional Unemployment', *European Economic Review*, 41 (1997), 905-914, pp. 905-906; Marek Góra, 'Central and Eastern European Labour Markets in Transition', in *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*, edited by Salvatore Zecchini (Dordrecht: Kluwer Academic/OECD, 1997), pp. 393-412, p. 395.

¹⁰ Václav Klaus, *Václav Klaus Narovinu. Hovory V.K. s Petrem Hájkem Nejen o Tom, Co Bylo, Je a Bude* (Praha: Rabbit and Rabbit, 2001), pp. 192-193.

dampen the initial pressure on companies to restructure through labour shedding.¹¹ In addition to historical and cultural links, the border with Germany permitted cross-border employment,¹² whilst significant inflows of tourists and one of the highest rates of FDI inflows in Central and Eastern Europe generated new employment opportunities for the Czech labour force.¹³

Another advantage in the Czech economy that positively limited unemployment levels, even with restructuring occurring, came from the historically developed structure and market heritage of the Czech economy. This meant that enterprises established before the Communist period normally had locations determined by market forces that are economically rational, whereas more recent plant was generally located in accordance with other objectives, especially the levelling of regional disparities.¹⁴ Other structural developments in the economy during transformation have allowed for the employment of both skilled and unskilled labour reserves, such as the rapid growth of the service sector that had been artificially suppressed under Communism. Marked sectoral responses in overall employment are visible in the Czech transformation, with labour flowing out of agriculture and industry into services, and also moving jobs within companies and

¹¹ Martin Raiser, 'Governing the Transition to a Market Economy', *Economics of Transition*, 3 (1995), 215-246, p. 226.

¹² Pertti Koistinen, 'The Employment Policy in the Making: Search for National Solutions in Central and Eastern Europe', in *Labour Markets in Transition: Employment, Unemployment and Labour Market Policies in Central and Eastern Europe*, edited by Birgit Pfau-Effinger, Marion Neufeld and Volkmar Kreißig, Working Paper, 1 (Gelsenkirchen: SAMF, 1994), pp. 11-46, p. 17.

¹³ Raiser, 'Governing the Transition', p. 219.

¹⁴ John C. Ham, Jan Svenjar and Katherine Terrell, 'Unemployment and the Social Safety Net During Transitions to a Market Economy: Evidence from the Czech and Slovak Republics', *American Economic Review*, 88 (1998), 1117-1142, p. 1132.

industrial sectors in response to a rationalisation of production.¹⁵ In particular, the concentration of agricultural employment in Slovakia favourably benefited aggregate unemployment measurements for the Czech Republic after the Velvet Divorce.¹⁶

An additional cause of low aggregate unemployment consistent with restructuring has been substantial outflows of labour from the labour force, primarily amongst pensioners, women and marginal groups including the disabled. Such reductions in employment do not result in increasing unemployment when they represent a reaction against enforced participation in the socialist model. After transformation began, the participation of pensioners fell from 520,000 in 1989 to less than 270,000 in 1997¹⁷ through voluntary losses or redundancy. These can be beneficial to firms if they represent a loss of unproductive labour with wage cost reductions in excess of the decline in productivity. Nonetheless, continued reductions in aggregate labour supply could become increasingly costly to the economy as a whole, and thus countering the effects of privatisation as a catalyst to the overall transformation. As well as potentially representing a loss of skills and experience from the labour force, although the current retirement ages are unlikely to be reduced, the already low mean age of pensioners and high dependency ratios this engenders combine to generate strong fiscal pressures on social security provisions.¹⁸

¹⁵ Vladislav Flek, 'Employment Structure and Unemployment in the Czech Republic', *Prague Economic Papers*, 8 (1999), 195-207, p. 206; Tomáš Konečný, *Changing Labour Market - Will the Czech Republic Succeed in Combating the Unemployment*, Unpublished paper given at Rajik Lázsló College Third Central European Conference, Pécsvarád, 10-16 April 2000, [n.p].

¹⁶ CCET/OECD, *Review of the Labour Market in the Czech Republic* (Paris: OECD, 1995), p. 21.

¹⁷ Marie Frýdmanová, Kamil Janáček, Petr Mareš and Tomáš Sirovátka, 'Labor Markets and Human Resources', in *Ten Years of Building Capitalism: Czech Society After 1989*, edited by Jiří Večerník and Petr Matějů (Praha: Academia, 1999), pp. 21-43, p. 32.

¹⁸ Tito Boeri, Michael C. Burda and János Köllő, *Mediating the Transition: Labour Markets in Central and Eastern Europe* (London: Institute for East-West Studies/CEPR, 1998), p. 4.

Similar effects arise with enforced exit, when labour withdraws from the available labour force if it does not expect to find employment, or wages are not adequate to retain these people.¹⁹ The loss of many women from the labour force strongly reflects the increasing costs of child-care and the discontinuation of social provisions by enterprises. These changes cause higher reservation wages amongst mothers before they would choose employment and be able to afford adequate child-care,²⁰ despite an extension of maternity leave by 12 months to three years, as well as higher allowances for children up to four years old.²¹

Also, the Czech authorities stringently enforced the rules on unemployment benefits to encourage job seeking rather than evasion and benefit fraud, so marginal groups are more likely to either take work that they would otherwise refuse with higher transfer payments, or withdraw totally from the potential supply of labour, and so become discounted from statistical unemployment measures.

Between 1994 and 1996 low unemployment co-existed alongside rising real wages,²² but this was unsustainable in the long-term because it creates conditions for the build-up of wage-push inflation that can reduce the competitiveness of firms. Rising unemployment from 1997 reflects changed institutional pressures on firms and labour from stronger market forces to economic efficiency, but is only beneficial as a restructuring strategy if

¹⁹ Tito Boeri and Christopher J. Flinn, 'Returns to Mobility in the Transition to a Market Economy', *Journal of Comparative Economics*, 27 (1999), 4-32, pp. 4-5.

²⁰ Robert S. Chase, 'Markets for Communist Human Capital: Returns to Education and Experience in the Czech Republic and Slovakia', *Industrial and Labor Relations Review*, 51 (1998), 401-423, p. 404.

²¹ Michal Rutkowski, 'Labour Market Policies in Transition Economies', *Mocst-Most*, 6 (1996), 19-38, p. 10.

²² Flek, 'Employment Structure', p. 201.

there is a rationalisation of labour use within firms. In some cases, labour shedding increased as budget constraints have hardened for firms, but this can have negative consequences for aggregate unemployment. As the transformation progresses, fewer employment opportunities exist in previously growing sectors of the economy, with the absorptive capacity of the economy from this aspect of structural change in decline.²³ Demographic factors such as the higher birth rates of the 1970s are also causing increased labour flows into already saturated markets, as well as marked regional variations in unemployment rates.²⁴ These exacerbate difficulties for firms needing to shed labour if they are tightly embedded into their local communities with implications for productivity as described further in section 6.3, but more generally are significant because they mean rising unemployment does not necessarily mean that such restructuring is occurring in Czech firms.

As the preceding discussion has shown, unemployment levels in the Czech Republic have responded to a number of institutional influences aside from unemployment caused by enterprise restructuring strategies of firms. Notwithstanding these factors that have helped reduce aggregate unemployment levels in the economy, the extent of labour shedding as part of the restructuring strategy of owners and managers is subject to additional institutions. These are considered in the following section that demonstrates

²³ Flek, 'Employment Structure', p. 206.

²⁴ Alois Holub, 'Rising Unemployment in the World Economy and the So-Called Czech Paradox', *Prague Economic Papers*, 3 (1993), 337-351, pp. 348-349; Heinz Fassmann, 'Unemployment in East-Central Europe and its Consequences for East-West Migration', in *People, Jobs and Mobility in the New Europe*, edited by Hans H. Blotevogel and Anthony J. Fielding, European Science Foundation (Chichester: Wiley, 1997), pp. 169-186, pp. 176-177.

whether privatisation encourages restructuring through lay-offs when this is an economically desirable strategy, or if there are institutional influences that prevent this.

The formal policy response of the post-communist Czech governments in dealing with unemployment provides the context within which labour responds to altered unemployment opportunities. It also influences the decisions of owners and managers to introduce restructuring measures that will impact on employment levels in their firms. Rigidity in labour flows can be institutionalised into an economy through measures aimed at the legal protection of workers rights, especially where labour unions are strong. This has been true historically in the centrally planned economies, and expectations of worker protection derived from experience of this system can continue to prevent restructuring occurring in firms to the extent that is economically desirable. This can justify the use of labour market interventions in response to distortions that can be rectified through such policies, but it is essential that these are motivated by efficiency, rather than equity concerns, if they are to promote restructuring within privatising firms.²⁵

As transformation progresses, the government needs to determine whether to tolerate labour under-utilisation by continuing soft budget constraints and artificially inflating the demand for labour through non-market measures, or whether unemployment should be made visible.²⁶ In the Czech Republic, new social security provisions have been made that can encourage companies to shed labour more easily and also restrict direct social

²⁵ Boeri *et al*, *Mediating the Transition*, p. 69.

²⁶ Boeri and Flinn, 'Returns to Mobility', pp. 4-5.

assistance within the enterprises, permitting a more rational employment structure to emerge.²⁷

6.2 UNEMPLOYMENT POLICIES.

In the Czech transformation, much direct government intervention through social assistance is discernible, because of a primacy placed on maintaining domestic social peace,²⁸ in contradiction to Klaus' professed neo-liberalism. Czech labour market policies have a dual emphasis on minimising social costs of transformation, with transfer payments and wage restraint to moderate labour flows out of enterprises, whilst simultaneously attempting to encourage re-employment of labour.²⁹ They aim to allow credible hard budget constraints for enterprises that will encourage restructuring, and the provision of a basic social safety net to protect labour against the search costs of unemployment.³⁰ Although they can be criticised for artificially inflating unemployment by alleviating the discipline of market forces against labour,³¹ in the Czech Republic the parallel developments of labour market policies to receive and redistribute this labour

²⁷ Boeri, *Transition with Labour Supply*, p. 13.

²⁸ Peter Rutland, 'Thatcherism, Czech-Style: Transition to Capitalism in the Czech Republic', *Telos*, 94 (1992-1993), 103-129. Academic Search Elite. EBSCO Publishing. 8 May 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; Mitchell Orenstein, 'Transitional Social Policy in the Czech Republic and Poland', *Czech Sociological Review*, 3 (1995), 179-196, p. 180.

²⁹ Rutkowski, 'Labour Market Policies', p. 28; Nicolas Spulber, *Redefining the State: Privatization and Welfare Reform in Industrial and Transitional Economies* (Cambridge: Cambridge University Press, 1997), p. 181.

³⁰ Ferdinando Targetti, 'The Privatization of Industry with Particular Regard to Economies in Transition', in *Privatization in Europe: West and East Experiences*, edited by Ferdinando Targetti (Aldershot: Dartmouth, 1992), pp. 1-29, pp. 22-23.

³¹ Richard Jackman and Catalin Pauna, 'Labour Market Policy and the Reallocation of Labour Across Sectors', in *Lessons from the Economic Transition: Central and Eastern Europe in the 1990s*, edited by Salvatore Zecchini (Dordrecht: Kluwer Academic/OECD, 1997), pp. 373-392, pp. 385-386.

appears to have positively impacted aggregate unemployment in the economy, and encouraged labour redistributions within enterprises as restructuring occurs after privatisation. The precise form and content of these labour market policies is presented below, because these determine levels of unemployment that in turn decide the incentives for labour to flow into more productive uses, and influence the extent to which decision-makers respond to the need for labour redistributions and restructuring.

6.2.1 *Passive Labour Market Policies.*

The level and duration of unemployment benefits introduced from 1990 in Czechoslovakia are amongst the lowest in Central and Eastern Europe, appearing stringent in comparison with Western Europe, but liberal in contrast to the USA.³² This unemployment compensation system (UCS) gave benefits payable for 12 months at 60% of the claimant's previous average wage for the first six months, falling to 50% for a subsequent six months. In cases of redundancy, payments in the initial six months were 65% of the previous wage. These workers were also entitled to claim severance pay,³³ but they could not collect unemployment benefit until these payments ended. Those who had not received a wage previously but were still eligible had their benefits calculated in accordance with the minimum wage. This replaced the benefits payable from 1989 of 95% of previous income for six months, falling to 60% for the next six months for those

³² Ham *et al*, 'Unemployment and the Social Safety Net', p. 1122.

³³ From 1990-1991 under Decree of the Federal Ministry of Labour and Social Affairs 312/1990 this was equal to five months average wage, but it was reduced to two months when this Decree was replaced by Redundancy Law 195/1991. Janice Bell and Tomasz Mickiewicz, 'EU Accession and Labour Markets in

dismissed through enterprise reorganisations, and the flat rate of 60% of previous income for 12 months for all others becoming unemployed.³⁴ Eligibility until 31 December 1991 required that a claimant had worked for a minimum of one year in the preceding three years, and had not claimed unemployment benefit in the previous six months, although this was waived for new graduates from school or university. Also those who had been unable to work for at least 12 months in the previous three years because they were caring for young children, sick or elderly relatives, serving in the military, or were in prison, were entitled to assistance. Any worker who had been dismissed or who voluntarily resigned persistently was not entitled to benefits for the initial six months of unemployment. From January 1992 benefits were reduced because of the high costs of the original scheme and the disincentive effects it engendered against the unemployed seeking work.³⁵ Eligibility criteria for those who had not been in the labour force for 12 months in the preceding three years only applied to those caring for young children. The duration of benefit payments was halved, with those who became unemployed after 1 July 1991 only receiving a maximum of six months payments. Redundant workers could only claim 60% of their previous wage, although for workers undergoing training it was 70%. For those who had not worked previously, the payments were 60% of the minimum wage, falling to 50% after three months. A ceiling on benefit payments of 150% of the minimum wage was imposed, but households where the total combined income from wages and UCS payments did not reach the minimum living standard,

the Visegrad Countries', in *Back to Europe: Central and Eastern Europe and the European Union*, edited by Karen Henderson (London: UCL Press, 1999), pp. 129-150, p. 135.

³⁴ Jenő Koltay, 'Unemployment and Employment Policy in Central and Eastern Europe: Similarities and Differences', in *Unemployment and Labor Markets in Central and Eastern Europe*, edited by Marvin Jackson, Jenő Koltay and Wouter Biesbrouck (Aldershot: Avebury, 1995), pp. 1-30, p. 20.

³⁵ Svenjar, 'Labor Market Adjustment', [n.p.].

additional social assistance was available. After six months, workers still had to remain registered and therefore actively seek work to be eligible for social welfare and other benefits such as health insurance and employment counselling.³⁶ Further reductions were introduced in January 1998 with a 10% reduction in existing benefit levels.³⁷

Critics of UCSs argue that stressing equity can have negative consequences for efficiency in labour markets. The degree to which benefits provide the recipient with adequate financial security can reduce the incentive for job searching and lengthen the time spent in unemployment. Given the low level of benefits introduced during the transformation, this effect is unlikely to be severe in the Czech transformation, although consistent with such a disincentive hypothesis, unemployment did fall after the restrictions on receiving unemployment benefits were tightened in 1992.³⁸

Employment policies in transitional economies need to ensure that economic growth results and living standards increase, bringing visible benefits and minimising social problems.³⁹ Over time unemployment increasingly becomes structural, requiring labour markets to be restructured if this is not to result in long-term unemployment, particularly amongst the least-skilled labour. To counteract this, a commonly favoured alternative to

³⁶ Ham *et al.*, 'Unemployment and the Social Safety Net', pp. 1122-1123; Henrik Huidfeldt, *Unemployment and the Labour Market Transitions in the Czech Republic: Evidence from Micro-Data*, Department of Economics Working Paper, 5 (Uppsala: Uppsala University, 1998), pp. 4-5.

³⁷ OECD, *Czech Republic 1997-1998*, p. 124.

³⁸ Svenjar, 'Labor Market Adjustment', [n.p.]; Alena Nešporová and Vera Uldrichová, 'Employment Policies and Programmes in the Czech Republic' in *Employment Policies and Programmes in Central and Eastern Europe*, edited by Martin Godfrey and Peter Richards (Geneva: ILO, 1997), pp. 47-75, p. 54.

³⁹ Ham *et al.*, 'Czech Republic and Slovakia', p. 143.

passive policies is the use of proactive measures, and this has been a key element of the Czech governments' response to unemployment.⁴⁰

6.2.2 Active Labour Market Policies.

The use of active labour market policies (ALMPs) in the Czech Republic preceded the changes in labour market policies introduced from 1 January 1992 from predominately passive to active methods of support.⁴¹ Government assistance to workers to ensure that full employment was achieved with central planning was a precursor to such interventions, but being motivated simply by ideological considerations, it was inappropriate to continue this in the transformation.⁴²

In response to increasing unemployment rates, 76 District Labour Offices (DLOs) were established by November 1990, and others were later opened.⁴³ Their main role as specified in the Employment Act is to provide retraining schemes that address the specific unemployment difficulties in their regions.⁴⁴

⁴⁰ Kamil Janáček, 'Unemployment: The Most Pressing Social Problem in Czechoslovakia', *Prague Economic Papers*, 2 (1993), 259-264, p. 263.

⁴¹ Tito Boeri and Michael C. Burda, 'Active Labour Market Policies, Job Matching and the Czech Miracle', *European Economic Review*, 40 (1996), 805-817, p. 807.

⁴² David Fretwell and Richard Jackman, 'Labor Markets: Unemployment', in *Labor Markets and Social Policy in Central and Eastern Europe: The Transition and Beyond*, edited by Nicholas Barr (Oxford: Oxford University Press/World Bank/London School of Economics and Political Science, 1994), pp. 160-191, pp. 163, 165.

⁴³ Miroslav Hiršl, Jiří Rusnok and Martin Fassman, *Market Reforms and Social Welfare in the Czech Republic: A True Success Story?*, Occasional Paper, 50 (Florence: UNICEF International Child Development Centre, 1995), p. 9.

⁴⁴ Kamil Janacek, 'Unemployment and the Labor Market in Former Czechoslovakia and the Czech Republic', in *Unemployment and Labor Markets in Central and Eastern Europe*, edited by Marvin Jackson, Jenő Koltay and Wouter Biesbrouck (Aldershot: Avebury, 1995), pp. 49-70, p. 49.

An overall budget for ALMPs is set annually by the government. To encourage efficient use of these funds, they are apportioned between regions in accordance with their labour market conditions, ALMP participation rates, and the past performance of the originating DLOs.⁴⁵ The National Labour Ministry examines the labour markets and devises employment and training programmes as precautionary measures on the basis of observed trends that are implemented by the DLOs. The main aspect of their work has been the creation of subsidised “social jobs”. These can be subsidies to new enterprises, although a specific programme was established to deal with unemployment amongst young graduates from further and higher education. Employers would receive a subsidy equivalent to the minimum wage if they created a suitable *assistent* or *praktikant* position for a new graduate for one year.⁴⁶

In general, training became a more attractive option following the changes made to the UCS from 1992, not only because the duration of benefits was shortened, but also because benefits payable were proportionally higher for those in training than for other workers.⁴⁷ From 1994, the Czech governments have focused on targeted ALMPs in recognition of their greater value to the unemployed, especially long-term and problem groups, but it is essential that their implementation is counter-cyclical to maximise the policy’s effectiveness.⁴⁸ Successes of the employment offices are not simply due to their

⁴⁵ Boeri and Burda, ‘Active Labour Market Policies’, p. 810.

⁴⁶ Alena Nesporova, ‘Recent Labor Market Developments in Former Czechoslovakia’, in *Unemployment and Labor Markets in Central and Eastern Europe*, edited by Marvin Jackson, Jenő Koltay and Wouter Biesbrouck (Aldershot: Avebury, 1995), pp. 71-91, pp. 86-87.

⁴⁷ Boeri and Burda, ‘Active Labour Market Policies’, p. 808.

⁴⁸ Gunther Schmid, ‘Institutional Incentives to Prevent Unemployment: Unemployment and Active Labour Market Policy in a Comparative Perspective’, *Journal of Socio-Economics*, 24 (1) (1995), 51-102. Academic Search Elite. EBSCO Publishing. 17 June 1999.

extensive remit and the significant amounts of government expenditure on ALMPs in comparison with all other labour market policies. There are also low ratios of unemployed persons for each employment advisor, allowing more intensive and personal job and training searches to be undertaken,⁴⁹ and strict criteria to ensure that those registered as unemployed are actively seeking work. Workers are strongly encouraged to accept the jobs offered to them,⁵⁰ even if these are not fully commensurate with their expectations.

The decline in unemployment after 1991, shown in Table 6.1, is attributable more to the extensive outflows from unemployment into work, rather than low levels of layoffs.⁵¹ This suggests that the introduction of ALMPs has been effective in combating unemployment. ALMPs are seen as superior to passive policies because they deal with the causes of structural mismatches between labour demand and supply by altering the infrastructure and institutional framework to increase labour absorption. Retraining reduces the incentive of labour to cease searching for employment and become dependent upon social assistance. As this makes the net costs significantly lower than the gross costs, ALMPs can often be more cost-effective than passive policies in the long-term.

<<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; Tomáš Sirovátka, 'On the Role and Perspectives of the Labour Market Policy in the Czech Republic', *Prague Economic Papers*, 5 (1996), 28-40, p. 36.

⁴⁹ Boeri and Burda, 'Active Labour Market Policies', p. 806; Gitter and Scheuer, 'Low Unemployment', [n.p.].

⁵⁰ Boeri *et al*, *Mediating the Transition*, p. 84; Huidfeldt, *Unemployment*, p. 5.

⁵¹ Boeri and Burda, 'Active Labour Market Policies', p. 806; Góra, 'Central and Eastern European Labour Markets', pp. 395-396.

Table 6.1: Dynamics of Unemployment in the Czech Republic 1990-2000.

	Unemployment (%)	GDP Growth Rate (%)	Annual Mean Inflows to Unemployment (%)	Annual Mean Outflows to Unemployment (%)
1990	0.8	-1.2	N/A	N/A
1991	4.1	-11.5	0.9	17.1
1992	2.6	-3.3	0.9	26.6
1993	4.4	-0.9	0.7	22.0
1994	4.4	2.6	0.6	21.3
1995	4.1	5.9	0.6	21.3
1996	3.9	3.8	0.6	19.3
1997	4.8	0.3	N/A	N/A
1998	6.5	-2.3	N/A	N/A
1999	8.8	-0.2	N/A	N/A
2000	8.5	1.8	N/A	N/A

Sources: Ham *et al*, 'Unemployment and the Social Safety Net', p. 1119; OECD, *Czech Republic 2000*, pp. 212, 214; Czech Statistical Office, <<http://www.czso.cz>>.

The labour involved in ALMPs in the Czech Republic is dynamic, comprising 1% of the labour force in 1991, nearly 3% in 1992, but falling again to just over 1.4% in 1994.

Holding pools of stagnant labour resources are therefore not being created, and periods of unemployment are reasonably short, which differs from other countries of the region.⁵²

This is a major reason for the success of these ALMPs since it is easier and less costly to move the short-term unemployed into employment than for those who have been out of the labour force for longer.⁵³ Another crucial aspect is that unemployment was still fairly low when the Czech government gave ALMPs precedence over passive policies in the transformation, so the relative proportion of skilled and higher productivity workers, who are those amongst the unemployed most likely to find new employment and respond to ALMPs, exceeded that of other countries in the region.⁵⁴ Diversity in labour in the unemployment pool at the outset of the transformation arose because managers sought to

⁵² Ham *et al*, 'Unemployment and the Social Safety Net', p. 1117.

⁵³ Bell and Mickiewicz, 'EU Accession', p. 144.

⁵⁴ Boeri, 'Heterogeneous Workers', pp. 911-913.

keep only the best labour when rationalising their labour resources, but had little guidance in screening labour on the basis of their past performance.⁵⁵

ALMPs are not without their critics, for it is not clear that there is a causal relationship between their implementation and reductions in unemployment.⁵⁶ To the extent that placed labour would have found work without help, it represents an inefficient use of resources, and this problem is exacerbated by the amount to which the most motivated rather than the most needy labour gains assistance. They are costly, so their use has to be selective for they do not give an immediate return,⁵⁷ but in assisting only a segment of the total labour available for employment, others are ousted from their position in the labour market. Another problem is that labour that is known to have participated in such programmes may be stigmatised as problematic. There also appears to be relatively few of the long-term unemployed involved in ALMPs in the Czech Republic that probably arises from self-selection and a favouring of high profile, frictional unemployed labour rather than other types of unemployed with their attendant and entrenched social difficulties.⁵⁸

The final criticism of such policies is that they can have contradictory effects, such as inhibiting wage restraint in view of the fact that workers participating in these schemes and undergoing retraining have an alternative to employment and so may have higher

⁵⁵ Boeri, 'Heterogeneous Workers', pp. 905, 908; Chase, 'Markets for Communist Human Capital', p. 405.

⁵⁶ Boeri and Burda, 'Active Labour Market Policies', p. 808; Rutkowski, 'Labour Market Policies', p. 23; Gitter and Scheuer, 'Low Unemployment', [n.p.].

⁵⁷ Fretwell and Jackman, 'Labor Markets: Unemployment', p. 162.

⁵⁸ Sirovátka, 'Role and Perspectives', pp. 35-36.

reservation wages to enter employment than if they were financially dependant upon the level of transfer payments.

Ultimately labour market policies only address the consequences of unemployment, but can benefit restructuring enterprises by facilitating labour shedding. Future developments on the labour market will depend on the institutional, and in particular the legislative environment of the government's employment policies. This makes it necessary to understand the patterns of labour flows in the economy and how far restructuring is supported by this framework. A National Employment Plan was introduced in May 1999⁵⁹ as a supplement to the unemployment policies and social assistance already in existence. It is integrally linked to these and other policies on social, regional and educational issues but it is more broadly designed to supplement the overall growth strategy of the government in preparation for accession of the Czech Republic to the European Union.⁶⁰ As the objectives for employment policy for European Union members are not binding and since the Czech Republic has to deal with some issues not relevant to existing member states, differences between the objectives in the Czech employment plan and those of current member states may be discerned. Overall the issues to be addressed are broadly similar, including the need to improve the existing skills and qualifications of the labour force, creating new jobs and facilitating movements into employment and improving matching between workers jobs and skills,

⁵⁹ Ministerstvo Práce a Sociálních Věcí, *National Employment Plan* (Prague: MPSV, 1999). 10 October 2000. <http://www.mpsv.cz/scripts/1ssz/narodni_plan/plan_eng.asp>, [n.p.]; *Changing Labour Market*, [n.p.].

⁶⁰ Ministerstvo Práce a Sociálních Věcí, *National Employment Plan*, [n.p.].

even under conditions of rising unemployment.⁶¹ However, it remains to be seen whether the necessary measures can be implemented whilst allowing enterprises in the Czech Republic to retain costs at a competitive level⁶²

Regardless of the strategy by which labour market efficiency is to be attained, the main impact required is increased productivity. Privatisation is ineffective if it does not promote this change that will help sustain overall restructuring within firms. During the Communist era capital depreciation was very severe, and low and declining real wages encouraged substitution of labour for other inputs, making production highly labour-intensive. Labour discipline was lax in state-owned enterprises as part of an implicit contract between the workers and management to maintain full employment,⁶³ with the result that “productivity was low as there were very many who were not doing anything” (Císař 3, Retired Analyst). This mentality still persists into the transformation, so whilst the institutional environment has altered and “now people know they work for money and this is an incentive, compared to the past where they had to work legally” (Rozdat Systems 2, Production Manager), this has not been fully overcome.⁶⁴ Instead, now, even with unemployment that “should make people increase their effort, there are still too many people who won’t work and who don’t want to work well” (Rozdat Systems 5, Financial Director).

⁶¹ Ministerstvo Práce a Sociálních Věcí, *National Employment Plan*, [n.p.]; Konečný, *Changing Labour Market*, [n.p.].

⁶² Bell and Mickiewicz, ‘EU Accession’, p. 131.

⁶³ Adam, *Employment and Wage Policies*, p. 36.

⁶⁴ Sharon L. Wolchik, *Czechoslovakia in Transition: Politics, Economics and Society* (London: RIIA/Pinter, 1991), pp. 243-244.

Productivity improvements are necessary if restructuring in privatised firms is to be successful, and as one director responded

the biggest problem throughout the Czech Republic is low productivity. Our main aim is to increase productivity but since 1996 there has been about a 30% decrease in this department. Low productivity is the main problem for businesses trying to be competitive (Rozdat Systems 4, Technical Director).

Nonetheless, as described below, there are conflicting institutional influences to labour achieving these gains.

6.3 PRODUCTIVITY AND EMPLOYMENT LEVELS.

Labour productivity in state-owned enterprises fell at the outset of transformation in Czechoslovakia, but unemployment levels were also low,⁶⁵ indicating that surplus labour was being retained in firms in the transformation. It is essential to determine whether the low rate of layoffs is integral to the restructuring strategy of firms, such that this reflects productivity gains where managers are “trying to find the optimal number of staff.

⁶⁵ Ham *et al*, ‘Czech Republic and Slovakia’, pp. 121-122; Gitter and Scheuer, ‘Low Unemployment’, [n.p.].

Where people were made unemployed the least productive workers were got rid of” (Rukopis Strojírny 1, Personnel Director), or if it is simply indicative of deferred restructuring.⁶⁶

In Czech firms, unemployment is often not the only mechanism by which increased labour productivity has been sought, with an emphasis also placed on altering the effectiveness of the existing labour resource. With privatisation, improvements in technology and consequently labour productivity have been seen in many firms. Evidence of this was highlighted for Rozdat Systems where there is

50% less staff than before but productivity is the same. The quality of staff is better and all the technical knowledge they must have is on a higher level. In 1991 there were around 500 employees and 7 computers. Now there are 320 employees and 160 computers (Rozdat Systems 4, Technical Director).

An alternative trend was visible in Přesnost KM where

a reduction in the classical production line led to a reduction in the share of workers with higher qualifications because the co-operation production that we have centred on since 1993 does not need workers with such high qualifications. Manual labour is more important here and so the qualifications structure has changed, although

⁶⁶ Martin Godfrey and Peter Richards, ‘The Struggle Against Unemployment: Medium Term Policy Options for Transition Economies’, in *Employment Policies and Programmes in Central and Eastern*

there are some production areas that need very highly qualified workers [and] decisions on unemployment have been made according to production changes in products so losses were not just in workers but in managerial positions too (Přesnost KM 1, Financial Planning Manager).

The corollary of this where the operating environment does not support such changes can result in production patterns not being significantly altered, with labour not acquiring new skills and so remaining tied to traditional methods of production. A respondent in Císař recognised this in their company, and felt that to overcome this

future changes are necessary in the technical equipment of the company.

Investment in technology and machinery is needed and buildings need to be renewed as modern technology will make production cheaper. We are still able to sell products in foreign markets as salaries remain low. However, the average age of the buildings is around 70 years old as investment in buildings has been minimal. The machinery is no better with its average age around 30-35 years. It is also a question of the perspective of the workers whose average age is 53 years. If people with a new perspective do not come, these will just leave the company and go to retirement and more people will not get qualified to work here in the short run as this is a long term process (Císař 2, Machine worker).

Since it remains cheaper for the company to continue with labour-intensive production because of the differential in wage costs between the company and its foreign competitors, there is reduced pressure to improve labour productivity and become more capital intensive, even if this would bring long-term benefits to the firm. This is exacerbated by the cost and extent of technological improvements needed to overcome the technological lag that developed during Communism.

Efforts to improve productivity in Drazitest have also been made by altering the skills of the labour force where the

management decided on unemployment on the basis of annual appraisals of productivity, so if it was low in some sector then they looked for ways to increase it, and one of these ways was to make some unemployed, but here this was the last option. Other alternatives for labour are for them to change qualifications, relocate to another department or change position within the teams in a given department (Drazitest 7, Personnel Manager).

These quotes importantly demonstrate for the case study firms how neo-classical economic considerations do not necessarily prevail in restructuring, with the prevailing attitudes and institutional environment within which restructuring is occurring moderating contemporary decisions. Assessing these empirically observed restructuring outcomes should therefore be done from a perspective of embedded institutionalism to account for adaptations to their environment.

In all of the companies studied, differences in training and qualifications of labour were noted, for

until 1989 training, recruitment, and education of employees was different because then it was taking place during working hours and it was an obligation. Nowadays the stress is on the initiative of the employees if they want to educate themselves. The company provides any training required by law and this is contracted out to outside companies. It used to be the state that took control of training and had quotas for this. Everything was planned, even the growth of qualifications, and the company had to go by whatever the state told them to do (Císař 1, Trade Union President).

This has brought improvements because people now have greater incentives to undertake training⁶⁷ since they “value work much more now and try to grow in their qualifications and building up their skills and knowledge to be better” (Brodchmel 1, Personnel Manager). This is because “now training is linked to quality norms” (Přesnost KM 2, Co-operation Plant Section Head), so whereas

⁶⁷ Jan Adam, *Employment and Wage Policies*, p. 76; Arvil V. Adams, *Labor Markets and Market-Oriented Reforms in Socialist Economies*, Presented at National Seminar on Labor Markets and Social Protection, Tashkent, June 7-11, 1993. 24 September 1999. <<http://www.worldbank.org/organisation/html/extdr/hnp/hddflash/hcwp/hrwp007.html>>, [n.p.]; Estrin, ‘The Inheritance’, in *Labor Markets and Social Policy in Central and Eastern Europe: The Transition and Beyond*, edited by Nicholas Barr (Oxford: Oxford University Press/World Bank/London School of Economics and Political Science, 1994), pp. 53-76, p. 61.

previously there was only “political” training and very little “professional” training, now the firm chooses labour that is already qualified for its specific activity but specialised training should also be given (Rozdat Systems 4, Technical Director).

However, difficulties remain with training, and productivity improvements are not assured because “it is difficult to find good specialist production that is very close to our demands for production” (Rozdat Systems 4, Technical Director). Another respondent illustrated the consequences of this, feeling that despite having

spent a lot of time on training, I have to be pessimistic over the results from this because what is most important is that the people want to change their behaviour. Going on a training course does not guarantee that they will change their behaviour or stereotypes but this depends on the person instead (Odras KM 2, Marketing Manager).

Productivity within firms can also depend on the legal requirements of unemployment policies. The creation of a social security system was an integral element of Czechoslovakia’s new government’s strategy to encourage labour shedding amongst firms, with the Employment Act seeking to eliminate state paternalism by placing the emphasis on individuals to seek employment opportunities and permitting more direct targeting of social policy measures.⁶⁸ For workers it replaced the “right” to a job with the

⁶⁸ M. E. Beesley and S. C. Littlechild, ‘Privatization: Principles, Problems and Priorities’, in *Privatization, Regulation and Deregulation*, edited by M. E. Beesley (London: Routledge/Institute of Economic Affairs, 1992), pp. 23-39, p. 26.

“right” to be helped to find a job or retraining, and to receive income support during periods of unemployment,⁶⁹ whilst giving employers the right to hire their own labour. The Act also specifies the criteria under which job contracts can be terminated,⁷⁰ so managers were aware that although they had strategic considerations in making workers unemployed, “it was also necessary to abide by legal requirements” (Rozdat Systems 5, Financial Director). Consequently, in making workers unemployed, firms

had to inform the DLO of workers listed for unemployment and furnish them with details of the workers’ characteristics, education etc and only those the DLO agreed could be listed for unemployment (Rukopis Strojírny 1, Personnel Director).

In Brodchmel, which is strongly embedded within the local environment, in making decisions on unemployment, additional measures were introduced that went beyond the legal requirements. As such,

immediate managers and supervisors made decisions over who should be laid off but were then involved in discussion with the trade union. From this department and the trade unions, people were made aware of what the situation is and they were helped to find jobs and told of what benefits they can do. The company paid them to look for jobs, giving them one day off a week, which exceeds the legal

⁶⁹ Ham *et al*, ‘Czech Republic and Slovakia’, p. 136; Nešporová and Uldrichová, ‘Employment Policies and Programmes’, p. 60.

⁷⁰ Martin Kápl, Milan Sojka and Tomáš Tepper, ‘Unemployment and Market-Oriented Reform in Czechoslovakia’, *International Labour Review*, 130 (1991), 199-210, p. 208.

requirement that is only half a day, and in many cases they were offered manual positions elsewhere within the company (Brodchmel 1, Personnel Manager).

By contrast, in Drazitest such links were weak and efficiency concerns predominated, so that

unemployment was mainly amongst those who were not a loss to the company.

There was some selection sensitive to social issues but there were limits to this too and the management would not lay off a skilled worker here in preference (Drazitest 3, Supplies Manager).

Mobility of labour is another factor impacting on productivity changes and, as a result, the restructuring that occurs within privatising enterprises. In market economies, labour flows are supposed to be determined by the interaction of demand and supply, but there are often significant constraints on the flexibility of labour to move because of legal issues as well as personal constraints to leaving one place of employment or even residence for another. In the Czech case there are important reasons to suspect that disincentives to change will be stronger because of greater frictions. Communism espoused the value of, and guaranteed a job for life so that workers expected “the company will retain them until they retire” (Císař 1, Trade Union President). Although inaccurate to claim that no labour market existed under the previous system since “workers had much more freedom to change jobs than usually thought, ... their skills

were non-transferable across jobs”,⁷¹ this only operated on the margins in areas of critical skill shortages.⁷² It can therefore be difficult for some workers to understand the need or benefit to changing jobs. Additionally, despite little loyalty to a firm being engendered amongst the labour force,⁷³ and a liberal policy on regional occupational mobility under central planning, labour mobility was in practice restricted by limited housing.⁷⁴ It remains a problem that even when mobility is desirable and recognised as such by the workers,⁷⁵ “problems with flats in the Czech Republic means that people cannot easily move to where good work is offered” (Rozdat Systems 5, Financial Director).

A related potential constraint limiting productivity improvements in firms is hidden unemployment. This should become obsolete as privatisation occurs and restructuring begins, but various forms of labour hoarding still occurs in privatised Czech enterprises. The extent to which labour is hoarded within firms will reflect a balance between the economic viability of the firm, and embedding through personal networks and retained mentalities as in Brodchmel where

relationships within the company from the past are unhealthy and too tight.

Workers keep their friends and if a certain person needs to be unemployed and it is too hard to go and do this, they try to avoid or circumvent doing this. This is a

⁷¹ Tito Boeri, *Transition with Labour Supply*, 5th Nobel Symposium in Economics, 6 December 1999. 30 September 2000. <http://www.cerge-ei.cz/events/sem-text/000210_t.pdf>, p. 14.

⁷² Jiří Večerník, ‘Labor Force Attitudes in the Transition to the Market: The Czechoslovak Case’, *Journal of Public Policy*, 12 (1992), 177-194, p. 186.

⁷³ Jiří Večerník, ‘The Emergent Labour Market and Job Prospects in the Czech Republic’, *Prague Economic Papers*, 4 (1995), 65-84, p. 66.

⁷⁴ Nuti, ‘Fighting Unemployment’, p. 40.

⁷⁵ Večerník, ‘Labor Force Attitudes’, pp. 182, 187; Frýdmanová *et al*, ‘Labor Markets’, pp. 28, 30.

principle from the era of socialism that everyone has a “right to work” (Brodchmel 2, Project Manager).

Other reasons for labour hoarding were that firms with excess labour can mobilise this with any given upturn in production, but the effect of such hoarding can be persistent unemployment where firms do not hire from the pool of unemployed labour in seeking additional staff,⁷⁶ as well as being costly and not requiring labour to changing its working patterns to be more flexible in the new environment. Managers can be unwilling to release labour as a consequence of historical considerations because

an employee was specialised and had one qualification so some kind of rotation of workers is not possible. It is better to keep a professional worker with qualifications as there may be a job in the future because it is harder to employ someone else who first needs training (Brodchmel 2, Project Manager).

Alluded to explicitly in Císař, a problem with this was recognised such that

if there is an area with particular products that is got rid of, workers and professionals will be laid off in this area. This decision cannot be reversed because the workers have been laid off and cannot go back to making these products any

⁷⁶ Christopher A. Pissarides, ‘Labour Hoarding in Industrial Countries: Concept and Measurement’, in *Employment and Unemployment in Economies in Transition: Conceptual and Measurement Issues* (Paris: OECD/CCEET, 1993), pp. 47-57, p. 47.

more as the workers are trained and skilled to do this and they cannot get these qualifications in the short run (Císař 3, Retired Analyst).

Further improvements in productivity do seem to be institutionally restricted in privatised Czech firms, in particular because of retained mentalities of labour and managers over the function of employment as being social as well as economic. Whilst there may not be a valid neo-classical economic rationale for the extent of labour hoarding and high levels of labour use in privatised enterprises, it appears that the formal and informal institutional environment does not support much additional change. Deferred restructuring in enterprises with employment levels remaining excessively high could therefore be a rational response to the institutional environment that owners, managers and labour within these firms operate under, with the benefits of this primarily social and political, not economic.

The final aspect of institutions relating to labour that can influence restructuring is the industrial relations framework. This represents institutional influences operating directly on the incentives facing labour to transfer between functions in the labour market, and so can influence the effectiveness of post-privatisation restructuring changes introduced into firms that prompt labour to consider changing employment. It also affects restructuring because firms have to respond to legal as well as informal institutional influences as these relate to employment and wages. The transformation has weakened the position of labour in enterprises, particularly as the trade unions have lost their legitimacy and bargaining role with the emergence of private ownership.

6.4 EVOLVING CZECH INDUSTRIAL RELATIONS.

Industrial relations under socialism operated quite differently from those of functioning capitalist economies. As industrial relations are contingent on underlying cultural conditions, directly transplanting existing but embedded institutional structures from other countries⁷⁷ is inappropriate. Diverse and fragmented interests are prevalent in the transformational economies, so it is not certain that a recognisable model from another context can emerge here.⁷⁸ However, as some of the main principles of industrial relations in capitalist economies are aims shared by the transforming economies; collective bargaining over wages and working conditions, protecting and motivating labour to work, and providing labour with a formal voice in the political system, similarities in the form of evolving industrial relations in the transformational economies and existing models is to be expected.⁷⁹ There is additionally a demonstration effect from functioning models in Western Europe and guidelines from international organisations such as the ILO. In Czechoslovakia these factors were instrumental in the creation of a tripartite structure to bring together representatives of government,

⁷⁷ Hans Slomp, Jacques van Hoof and Hans Moerel, 'The Transformation of Industrial Relations in Some Central and Eastern European Countries', in *Industrial Relations in Europe: Traditions and Transitions*, edited by Joris van Ruysseveldt and Jelle Visser (London: Sage/Open University of the Netherlands, 1996), pp. 337-357, p. 356.

⁷⁸ Sarah A. Vickerstaff and John E. M. Thirkell, 'Instrumental Rationality and European Integration: Transfer or Avoidance of Industrial Relations Institutions in Central and Eastern Europe', *European Journal of Industrial Relations*, 6 (2000), 237-251, p. 247.

⁷⁹ Richard B. Freeman, 'What Direction for Labor Market Institutions in Eastern and Central Europe?', in *The Transition in Eastern Europe, 2: Restructuring*, edited by Olivier Jean Blanchard, Kenneth A. Froot and Jeffrey D. Sachs, National Bureau of Economic Research (Chicago: University of Chicago Press, 1994), pp. 1-29, p. 19; Eckhard J. Dittrich and Michael Haferkemper, 'Labour Relations in the Making: Bulgaria, Hungary, Poland and the Czech Republic', in *Industrial Transformation in Europe*, edited by Eckhard J. Dittrich, Gert Schmidt and Richard Whitley (London: Sage, 1995), pp. 137-162, p. 138.

employers, and trade unions, theoretically independent of each other, into one consultative forum.⁸⁰

Privatisation has attributed specific importance to the tripartite structure and the agreements made within it,⁸¹ because the issues under discussion and policy content are dictated by the new economic and political paradigms of transformation. It is also important because it concerns issues that directly relate to labour and their incentives to change, since employees, as with other actors, embody particular retained mentalities and expectations from the era of central planning that have to be overcome if restructuring measures introduced into firms are to be carried out successfully.

6.4.1 Tripartism in the Czech Republic.

Between its creation in 1990⁸² and mid-1995, representatives of Czech trade unions, business associations and the government met as the RHSD (Council for Economic and Social Accord) to discuss wages and other labour related issues, and produce annual General Agreements covering employment and wage policies.⁸³ 1995 saw its

⁸⁰ Zdenek Janata, 'Formation of a New Pattern of Industrial Relations and Workers' Views on their Union: The Czech Case', in *Workers, Firms and Unions: Industrial Relations in Transition*, edited by Roderick Martin, Akihiro Ishikawa, Csaba Makó and Francesco Consoli (Frankfurt am Main: Lang, 1994), pp. 211-223, p. 212; Elena A. Iankova, 'The Transformative Corporatism of Eastern Europe', *East European Politics and Societies*, 12 (1998), 222-264, p. 227; Martin Myant, Brian Slocock and Simon Smith, 'Tripartism in the Czech and Slovak Republics', *Europe-Asia Studies*, 52 (2000), 723-739, pp. 723, 725, 726.

⁸¹ Jiří Kleibl and Zuzana Dvořaková, 'Industrial Relations in the Czech Republic', *Prague Economic Papers*, 8 (1999), 220-232, p. 227.

⁸² Separate Czech and Slovak Councils were established from 1993.

⁸³ Ivana Mazálková, 'The Trade Unions and the Transformation of Machinery Firms', in *Politics, Skills and Industrial Restructuring*, Institute of Sociology Working Paper, 8, edited by J. Vlášil, I. Hradecká, I.

replacement with the RSDP (Council for Dialogue between the Social Partners) when conflicts between the participants over the expectations and practical outcomes of the RHSD became unsustainable.⁸⁴ The agenda was restricted to “legal labour relations; collective bargaining and employment, wages and salaries, safety at work and social affairs”,⁸⁵ yet only two years later this was superseded by a reconstructed RHSD. In this new form its significance was much less prominent than when the RHSD was originally conceived.⁸⁶ Though the unions gained little from such a weak structure, the election of a Social Democratic government in 1998 has given tripartism a higher prominence in social bargaining negotiations,⁸⁷ so it continues to provide an institutional influence on restructuring decisions in enterprises.

Tripartism can describe a multitude of institutional arrangements “but it is also the case that different *partners* may hold differing conceptions at the same time”.⁸⁸ This caused many problems to arise in the Czech system because of “ambiguity from the start over the role, significance and permanence of the new tripartite structures”.⁸⁹ Legislative powers mean that the government is ultimately able to decide where agreement is reached, with some unwillingness to make all the agreements of the RHSD and RSDP legally binding or ensure their implementation, especially as transformation progresses

Mazálková and G. McDermott (Prague: Academy of Sciences of the Czech Republic, 1996), pp. 49-65, p. 49.

⁸⁴ Myant *et al*, ‘Tripartism’, p. 731.

⁸⁵ Kleibl and Dvořáková, ‘Industrial Relations’, p. 228.

⁸⁶ Lajos Héthy, ‘Central and Eastern Europe: Economic Transformation, Social Cohesion and Social Dialogue’, in *Economic Developments and Reforms in Cooperation Partner Countries: The Social and Human Dimension*, edited by Reiner Weichardt (Brussels: NATO Economic Directorate and Office of Information, 1997), pp. 9-16, p. 14.

⁸⁷ Myant *et al*, ‘Tripartism’, pp. 732-733.

⁸⁸ Myant *et al*, ‘Tripartism’, p. 724.

⁸⁹ Myant *et al*, ‘Tripartism’, p. 727.

and there is a shift away from social to economic goals for employment policy in the Czech Republic.⁹⁰ “General Agreements” to legislate for a minimum wage at least 50% of average wages as in the European Union were signed between 1991 and 1994,⁹¹ but the government had already broken the first within six months of it being signed, and by 1994 even the unions regarded them as superfluous because of their limited legal authority and the rapid growth of the new private sector that has undermined the importance of unionisation and collective bargaining.⁹² Much of the reluctance by the Czech government now to continue tripartite discussions comes from its decreasing need to compromise with other actors in the enterprise sector, because its role as an employer has declined drastically with privatisation.⁹³ It perceives tripartism to have simply evolved into a discussion forum where the reaction to any proposed changes in legislation that would impact on the broad areas with which the RHSD is concerned can be tested.⁹⁴ In keeping with its expectation that restructuring should be undertaken at the firm level by private owners, the government would prefer more decisions to be taken at the

⁹⁰ J. E. M. Thirkell, K. Petkov and S. A. Vickerstaff, *The Transformation of Labour Relations: Restructuring and Privatisation in Eastern Europe and Russia* (Oxford: Oxford University Press, 1998), p. 100; Roderick Martin and Anamaria Cristesco-Martin, ‘Industrial Relations in Transformation: Central and Eastern Europe in 1998’, *Industrial Relations Journal*, 30 (1999), 387-404, p. 394.

⁹¹ Alena Buchtikova, ‘Have Minimum Wages Hit Employment in the Czech Transformation?’, in *Minimum Wages in Central and Eastern Europe: From Prostitution to Destitution*, edited by Guy Standing and Daniel Vaughan-Whitehead, ILO-CEET (Budapest: Central European University Press, 1995), pp. 102-115, p. 102.

⁹² Héthy, ‘Central and Eastern Europe’, p. 15.

⁹³ Mazálková, ‘Trade Unions’, p. 50; Igor Tomeš and Vojtech Tkáč, ‘Former Czechoslovakia’, in *New Patterns of Collective Labour Law in Central Europe: Czech and Slovak Republics, Hungary, Poland*, edited by Umberto Carabelli and Silvana Sciarra (Milan: Giuffrè, 1996), pp. 61-99, p. 91.

⁹⁴ Mitchell Orenstein, ‘The Czech Tripartite Council and its Contribution to Social Peace’, in *Parliaments and Organized Interests: The Second Steps*, edited by Attila Ágh and Gabriella Ilonszki (Budapest: Hungarian Centre for Democracy Studies Foundation, 1996), pp. 173-189, p. 179; Myant *et al*, ‘Tripartism’, pp. 728, 732.

enterprise level in accordance with the specific conditions there, rather than using a tripartite structure that imposes top-down measures onto issues related directly to firms.⁹⁵

The continued existence of tripartite agreements in the Czech Republic appears to be a function of inertia, an uncertain future against which the discussions may provide some counterbalancing influence, and the derived legitimacy gained by participation.⁹⁶ Even if much of its tangible effectiveness is illusory,⁹⁷ the existence of a tripartite arrangement is essential to maintaining social peace in the economy and between the participants, and providing a supportive institutional context for enterprise restructuring to occur.

Amongst all of the actors involved, maintaining tripartism is probably most important for the trade unions, as membership provides them with legitimacy as a credible institution under the new political and economic conditions. By giving them a direct, formal political voice within the economy, and an opportunity to represent their interests in relevant issues such as collective bargaining over wages from a position independent of the state and enterprise management,⁹⁸ trade unions have to be considered as an institutional influence on observed restructuring outcomes. The nature and extent of this

⁹⁵ Buriánek, 'Industrial Relations Still in Transition', pp. 164, 171-172; Kleibl and Dvořáková, 'Industrial Relations', p. 228.

⁹⁶ Martin and Cristesco-Martin, 'Industrial Relations in Transformation', pp. 392-393; Anna Pollert, 'Trade Unionism in Transition in Central and Eastern Europe', *European Journal of Industrial Relations*, 5 (1999), 209-234, p. 229.

⁹⁷ Híršl *et al.*, *Market Reforms*, p. 6; Héthy, 'Central and Eastern Europe', p. 14.

⁹⁸ Vladimír Vrtiak, 'Management. Labour and Transition to a Market Economy in Czechoslovakia', *Bulletin of Comparative Labour Relations*, 27 (Special Issue) (1993), 153-164, pp. 153-155; Anna Pollert, 'From Acquiescence to Assertion?: Industrial Relations in the Czech Republic, 1989-1995', in *Industrial Relations Between Command and Market: A Comparative Analysis of Eastern Europe and China*, edited by Gerd Schienstock, Paul Thompson and Franz Traxler (New York: Nova Science, 1997), pp. 73-121, p. 89.

influence are discussed below, with particular reference to trade unions within the case study enterprises.

6.4.2 *Tripartism and Trade Unions.*

Transformation weakens the position of labour representation, for economic growth requires wages to remain at a competitive level, or capital intensity of production to increase. One respondent suggested that

trade unions have been in existence for many years in Western Europe and the need for them in the Czech Republic has been shown in the last ten years (Rozdat Systems 4, Technical Director).

However, despite their continued presence in the Czech Republic, the impact of trade unions on restructuring decisions, particularly when these have a negative impact on labour, has been limited. Notwithstanding efforts to increase worker participation in decision-making since 1989, traditions of effective labour participation in enterprises are institutionally weak. Pivotal to the operation of the centrally planned system, unlike in democratic market systems where their interests often conflict with those of the government and employers, trade unions had only a “transmission belt” role as agents of the government, implementing political decisions on behalf of the Party.⁹⁹ Consequently

⁹⁹ Joseph L. Porket, ‘Czechoslovak Trade Unions Under Soviet-Type Socialism’, in *Trade Unions in Communist States*, edited by Alex Pravda and Blair A. Ruble (Boston: Allen and Unwin, 1986), pp. 85-105,

it may prove difficult for workers representatives to be motivated and equipped to have their concerns heard within enterprises because of a lack of experience over how to accomplish this and its benefits.

Trade unions in principle are expected to have a formally institutionalised influence on restructuring, with employers required to generally aim to account for the trade unions as a partner organisation in the enterprise. Employers have to consult with, or inform the trade unions of their intended actions on certain decisions, specifically in the area of social policy, and on issues that concern the continued interests of employees, in particular those relating to the prognosis for the future strategic development of the enterprise.¹⁰⁰ There was some evidence of this in the companies studied where respondents described how

by law there are obligations on how the employer is supposed to communicate with the trade union for example over what profit the company is making or changes in employment (Císař 1, Trade Union President).

Consequently the firm has to be “involved in a collective contract with the trade union” (Brodchmel 1, Personnel Department), which resulted in one respondent commenting that the “management board has good communication with the trade unions as they are on the

p. 89; Martin Myant, ‘Czech and Slovak Trade Unions’, *Journal of Communist Studies*, 9 (4) (Special Issue) (1993), 59-84, p. 60.

¹⁰⁰ Freeman, ‘What Direction’, p. 4; Mazálková, ‘Trade Unions’, pp. 58, 62; Tomeš and Tkáč, ‘Former Czechoslovakia’, p. 74.

same side in the company” (Brodchmel 3, Assembly Section Head). Another worker saw a benefit from this for the trade unions in the transformation because

the trade union is now more important than before privatisation when it was on the same side as the directors. Now it is opposing the directors and trying to find how to make better solutions for the workers (Rukopis Strojírny 4, Machine worker).

The importance of this dialogue to labour in the case study firms though is ambiguous. Whilst labour can influence the impact of restructuring measures they implement, their influence on the decisions owners and manager make is much more restricted.

Of particular significance for the restructuring of labour relations in the post-communist transformation are the changes made to the Labour Code, which legally circumscribes all aspects of inter-enterprise relationships between the employees and their employers. It has been formally amended since 1989 to allow employers in the private sector to hire labour, permit dismissals, and end “collective agreements” in favour of negotiating methods used in liberal market systems. Minor amendments and a redrafted Labour Code passed in 2001 have been pursued to harmonise this with European Union labour market legislation.¹⁰¹ This is reflected in the work of the trade unions that is now “trying to get new laws to approach and follow European Union legislation” (Císař 2, Machine worker). However, the unions have lost much of their decision-making power as provisions in the revised Labour Code restrict their ability to prevent dismissals, and

circumscribe their role in decision-making processes in enterprises by limiting their influence on managerial strategies or decisions on restructuring.¹⁰²

Much of this represents only a nominal decrease in power for trade union independence in state-owned enterprises prior to 1989 was only in an organisational and not a functional respect.¹⁰³ Some strike action has occurred during the transformation, and this threat of action could prevent some firms from undertaking all the economically necessary restructuring desirable for the firm, if this would have a negative impact on labour. The frequency of such action though has been sporadic, with a lack of impetus and low expectations of its efficacy preventing this from being a technique of primary importance to the trade unions in the Czech Republic in constraining the management from taking decisions over restructuring with a detrimental effect on employment. The continued tolerance of a trade union presence in firms by management may be a tacit reflection of the fact that their true impact is limited, even where the interests of labour conflict with the overall intentions of the management or owners for restructuring in privatised firms.¹⁰⁴

Similarly, to many employees the trade unions are not seen to offer a credible institutional constraint against owners and managers initiating restructuring measures

¹⁰¹ Chris Brewster, 'Starting Again: Industrial Relations in Czechoslovakia', *International Journal of HRM*, 3 (1992), 555-574, pp. 567-568; Nesporova, 'Recent Labor Market Developments', p. 75.

¹⁰² Ludovit Cziria, 'The Czech and Slovak Republics', in *Labour Relations and Political Changes in Eastern Europe: A Comparative Perspective*, edited by John Thirkell, Richard Scase and Sarah Vickerstaff (London: UCL Press, 1995), pp. 61-80, pp. 72, 76; Pollert, 'From Acquiescence', p. 88.

¹⁰³ Porket, 'Czechoslovak Trade Unions', p. 89.

¹⁰⁴ Buriánek, 'Industrial Relations Still in Transition', pp. 164, 170; Martin and Cristesco-Martin, 'Industrial Relations in Transformation', p. 395.

with unfavourable effects on labour in their enterprises. That the old unions remained supportive of the KSC until it collapsed cost them much of their credibility,¹⁰⁵ whilst the new unions have often been unable to recruit new members through their inability to redefine their function successfully in the post-communist economy.¹⁰⁶ The Communist era unions were succeeded by the Czech and Slovak Confederation of Trade Unions (ČSKOS) as a co-ordinating body composed of representatives from individual unions holding to principles of autonomy, voluntarism and independence, protecting employees, and securing rights for the trade unions.¹⁰⁷ Union membership has become voluntary, and with the emergence of a new private sector where there is no tradition of unionisation, their aggregate importance has declined substantially.¹⁰⁸ According to one respondent,

in the past, trade unions had many rights and took part in decisions over everything. Now their role is different, their authority has reduced and they do most of their work in the social sphere. They cannot protect workers against unemployment and so have lost their authority (Rozdat Systems 3, Maintenance Supervisor).

¹⁰⁵ Krastyu Petkov and John E. M. Thirkell, *Labour Relations in Eastern Europe: Organisational Design and Dynamics* (London: Routledge, 1991), p. 218; Michael Burda, 'Unemployment, Labour Markets and Structural Change in Eastern Europe', *Economic Policy*, 16 (1993), 102-137, pp. 113-114.

¹⁰⁶ Buriánek, 'Industrial Relations Still in Transition', p. 168.

¹⁰⁷ Myant, 'Czech and Slovak Trade Unions', p. 62; Linda J. Cook, 'Labor Unions in Post-Communist Countries', *Problems of Post-Communism*, 42 (2) (1995), 13-18. Academic Search Elite. EBSCO Publishing. 7 October 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.].

¹⁰⁸ Bob Mason, 'Industrial Relations in an Unstable Environment: The Case of Central and Eastern Europe', *European Journal of Industrial Relations*, 1 (1995), 341-367, p. 355; Pollert, 'Trade Unionism', p. 211.

Other workers gave this loss of legitimacy as justification for not belonging to the trade unions. One felt that membership

is not necessary because they cannot help me. Trade unions are less powerful than before 1989 and should take increased interest in workers problems over unemployment for example, but they do not do this (Rukopis Strojírny 7, Foundry worker).

Another respondent left the union in 1989, feeling that

there was no reason or advantage to being a member. You have to pay a membership fee for this and the trade union represents all the workers but in a global way and cannot really have any influence for the individual (Císař 3, Retired Analyst)

This view is countered by the trade unions who argue that whilst

the trade union is responsible for all the workers in the company, not just the members, it offers some services and may advise the non-members, but for the members will do this for them and not just give advice (Císař 1, Trade Union President).

Formally

the trade union has to defend the rights of workers and annually sign an agreement on this with the management on issues such as social provisions and terms of wages (Rozdat Systems 7, Supervisor).

Nonetheless, even within the trade unions their changing role is recognised, with it freely admitted that the real reason for a change in their function and importance to employees “is mainly about money. There used to be a lot of tourist trips and we now have to cut back on these, but most of the work is done in the social sphere” (Rozdat Systems 7, Supervisor). Workers therefore do have valid concerns about the usefulness of the trade unions as a counter force to the restructuring measures introduced by owners and managers after privatisation.

Non-monetary compensations such as access to recreational facilities, health care and housing were provided by the enterprise during the Communist period. These had the advantage of equalising incomes and enforcing the obligation to work, but made it harder to link wages to productivity as benefits were available regardless of effort. Its equity, and the support of the trade unions ensured that the workers accepted it.¹⁰⁹ An important change in the transformation has come with the increased monetisation of social assistance and delinking of its provision from the workplace so that enterprise managers

¹⁰⁹ Adam, *Employment and Wage Policies*, p. 70; Anna Soulsby and Ed Clark, ‘Privatisation and the Restructuring of Enterprise Social and Welfare Assets in the Czech Republic’, *Industrial Relations Journal*, 26 (1995), 97-109, pp. 97-98.

no longer have to try and fulfil this role at the expense of economic efficiency.¹¹⁰ In particular, the creation of social security institutions rather than the use of full employment to deal with many social issues¹¹¹ recognises that “[p]eople should be protected by social policy and not by structural policy”.¹¹²

Communist-era traditions of welfare provision have created groups with strong vested interests in social protection against negative impacts from the reform process that could hinder transformation if their interests are not considered.¹¹³ Non-wage benefits can be manipulated to achieve social goals, but this does not preclude a need to alter wages because these directly impact on incentives of labour and therefore performance. Retaining low monetary wages can restrict the need for firms to restructure production and undertake capital intensive production methods by enabling managers to retain larger quantities of labour than economically efficient.¹¹⁴ This final section therefore considers post-communist wage policies, for these contribute to the efficacy of restructuring by altering the incentives of employees to work, and for employers to retain or shed labour.

¹¹⁰ E.V.K. FitzGerald, *Economic Reform and Citizen Entitlement in Eastern Europe: Some Social Implications of Structural Adjustment in Semi-Industrial Economies*, UNRISD Discussion Paper, 27 (Geneva: UNRISD, 1991), p. 14; Michaela Erbenová, Vit Sorm and Katherine Terrell, ‘Work Incentive and Other Effects of Social Assistance and Unemployment Benefit Policy in the Czech Republic in the Czech Republic’, *Empirical Economics*, 23 (1998), 87-120, pp. 89-91.

¹¹¹ Daniel Vaughan-Whitehead, ‘Minimum Wages in Central and Eastern Europe: Slippage of the Anchor’, in *Minimum Wages in Central and Eastern Europe: From Protection to Destitution*, edited by Guy Standing and Daniel Vaughan-Whitehead (Budapest: Central European University/ILO-CEET, 1995), pp. 15-48, p. 25; Nuti, ‘Fighting Unemployment’, p. 40.

¹¹² Horst Siebert, *The Transformation of Eastern Europe*, Weltwirtschaft an der Universität Kiel Discussion Paper, 163 (Tübingen: Mohr, 1991), p. 12.

¹¹³ Jan Adam, ‘Transformation to a Market in the Former Czechoslovakia’, *Europe-Asia Studies*, 45 (1993), 627-645, p. 637.

¹¹⁴ Ham *et al.*, ‘Czech Republic and Slovakia’, pp. 98, 112, 121-122; David Turnock, *The East European Economy in Context: Communism and Transition* (London: Routledge, 1997), p. 142.

6.4.3 Wage Policies.

Nominal wages have been slow to adjust in the Czech Republic despite rising unemployment. This indicates possible institutional obstacles or conflicting policy objectives constraining the operation of market forces,¹¹⁵ limiting restructuring because labour is responding to distorted signals. To the extent that wage inertia persists, labour will remain in industries that are not priority sectors under the new economic conditions until demand falls sufficiently and wages decline in response. Evolutions in wage policies are dictated by legislative developments, but affect restructuring within enterprises because labour then faces changed incentives to work given the new opportunities for remuneration.

Workers' understanding of the composition of wages and the incentive effect of bonuses was skewed with full employment. A basic salary was automatically paid to those present at work, and a bonus for completing the minimum tasks set, resulting in the ensuing loss of the incentive function that bonuses have in developed market economies.¹¹⁶ Socialist wage policies constituted "a conscious endeavour on the part of government to utilise the economic functions for the sake of improving the performance of the economy and the material situation of the population"¹¹⁷ with wages notionally determined in accordance with three components. Firstly, a tariff system assigned every

¹¹⁵ Flanagan, 'Wage Structures', p. 852; Klára Fóti, 'Employment and Unemployment in the "Visegrád Countries" and Slovenia' in *Changes and Challenges: Economic Transformation in East-Central Europe*, edited by Pál Gáspár (Budapest: Akadémiai Kiadó, 1995), pp. 69-88, p. 86.

¹¹⁶ Karen L. Newman and Stanley D. Nollen, *Managing Radical Organizational Change* (Thousand Oaks: Sage, 1998), p. 37.

¹¹⁷ Adam, *Employment and Wage Policies*, p. 67.

job a particular grade. More grades existed for non-manual workers because of the greater complexity of tasks undertaken. Pay scales for a given grade varied according to the status of the industrial branch and size of the enterprise, with administrative staff on lower salaries than the technical managerial grades. Secondly, the amount of work performed for which payment should be made had to be determined, which led, thirdly, to the establishment of work norms in order to ascertain workers contributions and the extent of their under- or over-fulfilment of their required tasks.¹¹⁸ Wage differentials actually responded more strongly to ideological impetus than economic justifications,¹¹⁹ with absolute wage differentials according to education and training experience quite limited as a result of small differences in course curricula, an increasing mismatch between overly skilled labour and positions for unskilled labour needing to be filled, and the costs of education increasingly assumed by the state.

Fearing inflation, which would be detrimental to restructuring in enterprises and transformation generally by increasing costs to adjustment, the government continued to tightly regulate wages in enterprises with some state ownership until 1995.¹²⁰ However, this could hinder change because politically dictated wage levels are unlikely to equate with that for the market-clearing level of marginal productivity.

¹¹⁸ Adam, *Employment and Wage Policies*, pp. 80-83.

¹¹⁹ Jiří Večerník, 'Changing Earnings Distribution in the Czech Republic: Survey Evidence from 1988-1994', *Economics of Transition*, 3 (1995), 355-371, p. 357.

¹²⁰ Klaus, *Česká Cesta* (Praha: Profile, 1994), pp. 42, 43-44; Daniel Vaughan-Whitehead, 'Wage Policy Reforms in Central and Eastern Europe: A First Assessment 1990-1996, in *Paying the Price: The Wage Crisis in Central and Eastern Europe*, edited by Daniel Vaughan-Whitehead (Basingstoke: Macmillan, 1998), pp. 13-80, p. 15.

Deriving from the tripartite agreements, in 1991 employers gained the right to bargain with trade unions over wages according to two alternatives, provided that minimum national wages and other provisions on working conditions were adhered to.¹²¹ A collective agreement could be signed with the trade unions that included provisions on wages, making the enterprise liable for the national minimum wage, but giving it discretion over the wages paid to workers of higher tariff grades. Alternatively, the enterprise could elect to automatically honour the minimum wage tariff set by the government for each grade.¹²² From 1991, the government began setting limits on wage bill growth with financial penalties to discourage employers from exceeding these, even though wages were a small part of total costs and therefore unlikely to contribute to inflationary pressures on either the demand or supply-side.¹²³ For the first half of 1992, wages were not regulated as no consensus could be reached over desirable levels of wage growth, but for state-owned enterprises limits were subsequently instigated under pressure from the IMF to attain economic stability throughout the economy. In 1993, agreement over wage regulation was again only attained in the second half of the year, with a return to the centralisation of wage tariffs.¹²⁴ Though a minimum wage and wage controls were introduced to help protect the lowest paid sectors of the labour force, the abolition of wage regulation in 1995 was welcomed by reformers pressing for increased marketisation of reforms, but also by the trade unions who gained increased flexibility in

¹²¹ Alena Nesporova, 'The Czech and Slovak Federal Republic: Labour Market Trends and Policies', in *Structural Change in Central and Eastern Europe: Labour Market and Social Policy Implications* (Paris: CCET/ILO, 1993), pp. 71-94, p. 91; Ham *et al*, 'Czech Republic and Slovakia', p. 118.

¹²² Buchtikova, 'Minimum Wages', pp. 104, 106; Vaughan-Whitehead, 'Wage Policy Reforms', p. 20.

¹²³ Vaughan-Whitehead, 'Wage Policy Reforms', pp. 49, 51, 53.

¹²⁴ Ham *et al*, 'Czech Republic and Slovakia', pp. 106-108; Daniel Vaughan-Whitehead, 'Wage Policy Reforms', pp. 15, 42.

wage setting.¹²⁵ As one respondent commented “the company needs a highly qualified labour force, but for this it has to be able to pay these people” (Císař 2, Machine worker). The retention of wage controls in the state sector had prevented the management from using salary increases and bonuses to retain the most qualified labour or to induce some members of the workforce to leave or transfer to other tasks in order to attain higher labour productivity.¹²⁶

Problems with wage regulation were compounded because the restrictions did not apply to foreign-owned and private firms, or those with fewer than 25 employees.¹²⁷ This ensured a flow of labour out of the declining state industries into other sectors where higher education and experience were rewarded with better jobs and wages.¹²⁸ One respondent described how this occurred throughout the economy as

a lot of smart people left and began their own business. Most were then successful but it was also because the big companies cannot give appropriate salaries to the very skilled workers. It was also because the companies can afford it but they are not interested in this because wages are tied up in the law and cannot change much.

Good management can and should pay workers an appropriate wage because they

¹²⁵ Jiří Večerník, *Markets and People: The Czech Reform in a Comparative Perspective* (Aldershot: Avebury, 1996), p. 50; Vaughan-Whitehead, ‘Wage Policy Reforms’, pp. 60-61.

¹²⁶ Joseph Prokopenko, ‘The Transition to a Market Economy and its Implications for HRM in Eastern Europe’, in *Human Resource Management in Europe: Perspectives for the 1990s*, edited by Paul S. Kirkbride (London: Routledge, 1994), pp. 147-163, p. 158; Turnock, *East European Economy in Context*, p. 181.

¹²⁷ CCET/OECD, *Review of the Labour Market*, pp. 17-18; Večerník, *Markets and People*, p. 52.

¹²⁸ Jana Hendrichova, ‘The Emerging New Relationship Between Higher Education and Employment in the Czech Republic’, *European Journal of Education*, 30 (2) (1995), 157-169. Academic Search Elite. EBSCO Publishing. 27 August 1999. <<http://www.global.epnet.com/hosttrial/login.html>>, [n.p.]; Olivier

know they will get a profit from this, but this does not exist in this company (Císař 3, Retired Analyst).

Higher wages in the private sector though may incorporate a premium to compensate for the lack of job security or loss of non-pecuniary benefits compared with employment in the state sector, rather than being a device to attract labour *per se*.¹²⁹ This may cause low mobility between the state and private sector. Workers may proactively choose employment in the state sector if this is perceived to offer more stable employment tenure than in the private sector where

owners do not take care of employees very well. Salaries are not regular and it is very dangerous to work for them as the new owners don't want to pay their workers. Odraž KM has been here a long time and although salaries are low, the company pays whenever it has the money. Some workers have returned to Odraž KM after going to work for smaller firms because although the salaries are lower they are nearly guaranteed compared to private firms (Odraž KM 3, Technical Designer).

Blanchard, 'Theoretical Aspects of the Transition', *American Economic Review*, 86 (2) (1996), 117-122, p. 117.

¹²⁹ Iraj Hashi and Mehrdad Emadi-Moghadam, 'Enterprise Behaviour in Transitional Economies', *Prague Economic Papers*, 2 (1993), 331-345, p. 335; Robert J. Flanagan, 'Wage Structures in the Transition of the Czech Economy', *IMF Staff Papers*, 42 (1995), 836-854, p. 834.

Also, movement into the private sector could be discouraged by limited pecuniary rewards, as few in the labour force have the skills necessary to command premium wages there, but their accumulated job experience is still rewarded in the public sector.¹³⁰

Wage liberalisation was therefore welcomed widely by employers and employees. Not only are “salaries more differentiated now, and skills as well as education matter now” (Drazitest 4, Researcher, but this allowed salaries to become part of the restructuring strategy of firms. Employers

want to give salaries that reflect qualifications and the quality of work. There is a need to overcome what was typical for the old system where it was very difficult for younger workers to get a good salary (Rozdat Systems 4, Technical Director)

When wages are linked to productivity, they include an incentive function, where

the main motivation for workers is money and the possibility to grow and to know that they have the opportunity to get higher positions if they are doing a good job (Drazitest 7, Personnel Manager),

which is beneficial to restructuring because it motivates labour to respond favourably to the changed working conditions, whilst simultaneously bringing benefits to the firm through higher productivity and efficiency gains.

¹³⁰ Chase, ‘Markets for Communist Human Capital’, p. 405; Boeri and Flinn, ‘Returns to Mobility’, p. 30.

6.5 CONCLUSION.

Institutionally, labour markets and the supporting industrial relations framework are essential to understanding observed restructuring outcomes in Czech enterprises after privatisation as these provide the context within which planned restructuring changes occur. Restructuring changes have to be implemented by labour and their incentives to adapt are determined by these legislative and institutional developments. However, in turn these mean that the potential choices of owners and managers are embedded into the institutional environment when restructuring impacts on the labour resource, which sets boundaries to economically desirable change.

Unemployment levels recorded in Czechoslovakia and the Czech Republic have been the lowest amongst all the countries of Central and Eastern Europe during the transformation. This has brought advantages to post-communist Czech governments because of the relatively low levels of expenditure required for easing the negative perceptions and effects of the transformation on labour. Since the transformation began, labour markets have increasingly responded to economic rather than political stimuli. However, labour mobility is still restricted in practice by factors such as housing shortages and uncertainty over real wages in a new job,¹³¹ which limits the overall levels of economic efficiency and growth that can be attained in the economy with restructuring after privatisation. Industrial relations also needed to be reconstructed during the transformation because of the changes to the organisation of production. Labour markets are being used to tackle

¹³¹ Rutkowski, 'Labour Market Polices', p. 17; Boeri *et al*, *Mediating the Transition*, p. 20.

issues of labour distribution throughout the economy to permit economic growth, but where wage growth is not linked to productivity, this risks inflationary pressures building up in the economy.¹³² Enterprises are beginning to separate social welfare provision from wages, and instead of full employment and job security policies, social security institutions have been established to protect the most vulnerable in society.¹³³ Despite this, individual negotiations over terms and conditions and collective bargaining are limited to social issues, which now restrict the ability of workers to participate in collective action.¹³⁴ Consequently the workplace has remained the primary domain of labour relations,¹³⁵ indicating that there are some institutional precedents from the Communist period retained by labour that could conflict with the changes desired by managers and owners.

The labour resource is an important institution to be considered when understanding observed restructuring within firms, being an institution in its own right as well as being affected by institutions that impact upon it through labour markets and the broader industrial relations framework. Privatisation has decreased the formal power acquired by workers within enterprises but the broader context of enterprise restructuring still allows workers to retain some *de facto* control within enterprises because of weaknesses in ownership and management that prevents all economically desirable changes being implemented. Furthermore, the institutional context of labour relations and labour

¹³² Adams, *Labor Markets and Market-Oriented Reforms*, [n.p.]; Frýdmanová *et al*, 'Labor Markets', p. 33.

¹³³ Adams, *Labor Markets and Market-Oriented Reforms*, [n.p.].

¹³⁴ Pollert, 'From Acquiescence', pp. 76, 105.

¹³⁵ Anna Pollert and Irena Hradecka, 'Privatisation in Transition: The Czech Experience', *Industrial Relations Journal*, 25 (1994), 52-63, p. 55; Ariane Hegewisch, Chris Brewster and Josef Koubek,

markets where the neo-liberal rhetoric of Klaus is not supported by the policies implemented also enhances the position of labour because retained mentalities over the extent of social assistance to labour further constrain managers and owners in shedding labour. Institutionalism therefore highlights an important tension for restructuring enterprises because formal institutions protect labour less now, but retained mentalities act as an informal institutional constraint on restructuring decisions. Observed restructuring outcomes therefore reflect the way this dichotomy is being resolved within individual firms, and how this interacts with the restructuring measures desired and implemented by owners and managers. This thesis has shown that there are institutional influences on all the actors involved with restructuring, and embedded institutionalism argues that these influences must be comprehensively understood to incorporate formal, informal, and enforcement aspects. In conclusion to the thesis, the final chapter discusses the impact of this embedded institutionalism perspective to assessing restructuring, and considers whether there is a unique Czech path of enterprise restructuring discernible from this perspective.

'Different Roads: Changes in Industrial and Employee Relations in the Czech Republic and East Germany Since 1989', *Industrial Relations Journal*, 27 (1996), 50-64, pp. 55, 62.

CHAPTER SEVEN

CONCLUSION: A “CZECH WAY”?

Having initiated reforms to effect the transformation from central planning to a market economy, Klaus' government desired privatisation to be the cornerstone of the process. This was inspired by neo-classical economics that predicts new private owners will restructure their firms because privatisation creates the incentives for this. However, it has been argued in this thesis that more than simply changing ownership through asset transfers is required for this to occur, and privatisation to be an appropriate and successful strategy of economic transformation. Rather, sufficient incentives must exist to ensure restructuring occurs once ownership changes have been made. Reviewing the findings of the preceding chapters, this thesis concludes that neo-classical economics does not correctly predict the restructuring processes of privatised firms in transformational economies. It has been shown from the case studies presented in this work that privatisation by itself is inadequate to promote restructuring, and consequently transformation, because of the presence and influence of institutions. Instead, the thesis argues that restructuring outcomes arise as a result of the extent to which firms and actors interact with, and are influenced by, these institutions. Embedded institutionalism has been developed in this work as an explanatory framework that can be used to account for the effects of institutional influences on observed post-privatisation restructuring outcomes.

An overarching view of the purpose and findings of each chapter from the perspective of embedded institutionalism is outlined below. Specific consideration is then made of how embedded institutionalism differs from neo-classical economics to reinforce

the appropriateness of the approach adopted in this work. Next, the chapter discusses an important conclusion of embedded institutionalism, illustrating how *de facto* control is the main determinant of the post-privatisation restructuring occurring, rather than *de jure* share ownership. This is followed by a wider assessment of the influence of institutions on observed post-privatisation restructuring outcomes.

Formal institutional structures can be altered quickly, but these need to become accepted and credible before they cause an alteration to informal institutions. Whilst the Velvet Revolution in 1989 represented a radical change from a power-political perspective, and despite formal changes in personnel and legislation, a lot of institutional and cultural continuity with the Communist regime persists in the post-communist era in formal structures,¹ and informally through behavioural patterns.² Understanding the impact of owners, managers and labour therefore represents a consideration of the influence of formal as well as the informal, and enforcement, aspects of institutions. It is shown that these are not only persistent, but that primacy needs to be given to the impact of informal institutions such as retained mentalities and consequent behavioural patterns arising from their impact.

Finally, it is proposed that the privatisation and consequent restructuring processes of formerly state-owned enterprises in the Czech Republic does not represent the emergence of a specific Czech paradigm. The Czech privatisation programme, in

¹ David F. Good, 'The Economic Transformation of Central and Eastern Europe in Historical Perspective', in *Economic Transformation in East and Central Europe: Legacies from the Past and Policies for the Future*, edited by David F. Good (London: Routledge, 1994), pp. 3-24, p. 4; A. D. Jankowicz, 'The New Journey to Jerusalem: Mission and Meaning in the Managerial Crusade to Eastern Europe', *Organization Studies*, 15 (1994), 479-507, p. 480; Paul G. Lewis, *Central Europe Since 1945*, Postwar World (Harlow: Longman, 1994), pp. 302, 303.

² Attila Agh, 'From Nomenklatura to Clientura: The Emergence of New Political Elites in East Central Europe', *Labour Focus on Eastern Europe*, 47 (1994), 58-77, p. 58; Karen L. Newman and Stanley D. Nollen, *Managing Radical Organizational Change* (Thousand Oaks: Sage, 1998), p. 61.

particular voucher privatisation where numerous small shareholders are created through a Walrasian-style auction, is distinct from the models of privatisation adopted in other post-communist countries of Central and Eastern Europe. Klaus' ideological position of giving primacy to domestic ownership, and the consequent need to overcome barriers of limited financial resources and experience to participation, are specific to Czechoslovakia and the Czech Republic, that could theoretically represent a distinct Czech model. However, this thesis argues that the design of the Czech voucher privatisation scheme simply reflects a response to the institutional environment within which it was introduced. Through embedded institutionalism, it is demonstrated that observed outcomes are a tangible reflection of the interactions between enterprises and their specific institutional environments, which causes restructuring outcomes to differ from those of other transformational economies, and that this not a distinct Czech model.

7.1 OVERVIEW OF THE CHAPTERS.

Restructuring outcomes in former state-owned enterprises privatised by voucher in the Czech Republic differ from those predicted to emerge by neo-classical economic theory. This thesis has shown that conceptualising how and why these outcomes arise, and that the processes leading to these cannot be understood unless the influence of institutions is accounted for. To the overall detriment of its effectiveness, the government's expectations for voucher privatisation remained guided by neo-classical economic theory, which, as shown by the embedded institutionalism framework, is inappropriate because of the presence and influence of institutions. Empirical evidence from case studies has been used in this work to illustrate the

nature and impact of institutional influences within firms on post-privatisation restructuring, demonstrating that observed restructuring outcomes in firms respond to socio-political as well as economic influences that vary temporally and spatially.

The first three chapters provided the foundation for assessing institutional influences within voucher privatisation firms from the perspective of embedded institutionalism. Having presented the methodological underpinnings of embedded institutionalism in the first chapter, the multifaceted review of the historical development of Czechoslovakia and the Czech Republic in Chapter Two demonstrated the global institutional context that defines the parameters within which privatisation, and the subsequent restructuring arising within former state-owned enterprises, occurs. This is particularly significant because it illustrates the way in which historical factors impact on contemporary restructuring outcomes, which has been developed by the path-dependency aspect of the embedded institutionalism framework. The impact of institutional influences on the design and implementation of the Czech privatisation process was then discussed in the third chapter, where it is argued that the effects of institutional influences on the outcomes of voucher privatisation were not explicitly recognised, to the overall detriment of its effectiveness.

In the remaining chapters, the embedded institutionalism approach was applied to assess and understand post-privatisation restructuring, with particular reference to changes made in the case study firms. Empirical evidence from the interviews conducted in these firms has been used to illustrate the observed outcomes and the means by which institutions caused these conditions to arise, whether or not respondents within the firms acknowledge these. Of particular relevance to

understanding the outcomes of enterprise restructuring are the actions of owners, managers, and labour as addressed in Chapters Four, Five and Six respectively. Each of these groups simultaneously operates within their own institutional environment, as well as being institutions in their own right. It has been shown that all of these have to be considered if the whole spectrums of restructuring processes are to be accurately discerned. In each case, changes in their function within enterprises brought about by transformation and privatisation mean that the temporal dimension of embedded institutionalism is needed to understand some of their behaviour, because any changes in formal institutions may not immediately be translated into tangible responses in the realm of informal institutions.

Of these three groups of actors, the study contends that managers have the greatest direct influence on the nature and extent of restructuring in privatising Czech firms. Institutionally contradictory corporate governance mechanisms currently exist, and this work concludes that this weakens the ability of owners to exercise control over their enterprises. Labour is an important, but usually indirect determinant of the restructuring that actually occurs in firms, being affected by institutional developments in the transformation as well as changes in the industrial relations framework. These dictate their feasible range of actions, as well as incentives to adapt to restructuring measures introduced, giving labour some *de facto* control over restructuring, albeit in a restricted sense.

In the following section a comparison between embedded institutionalism and the failings of neo-classical economic theory to predict post-privatisation restructuring outcomes in Czech voucher privatised firms is made. This underlines the validity of

the embedded institutionalism approach as an explanatory framework for the observed post-privatisation restructuring in Czech firms.

7.2 THE INFLUENCE OF INSTITUTIONS.

An important distinction needs to be made between privatisation as a technical procedure through which ownership transfers are achieved, and the subsequent process of enterprise restructuring that is not assumed to be an automatic consequence of privatisation due to the existence of institutions. Rapid ownership transfers are achieved through voucher privatisation, which is a positive attribute of the programme that the government desired for political reasons. However, this thesis concludes that insufficient consideration was given to the implications of incentives for post-privatisation restructuring that arise in response to the institutional environment. Institutions determine whether ownership transfers will result in sustainable restructuring that is beneficial to the enterprise, and if this can further the overall process of transformation within the economy, both being aspirations of Klaus for voucher privatisation.

Voucher privatisation in the Czech Republic represented a novel approach to asset transfers. Some consideration was given to the institutional conditions in its design, such as minimising the need for liquidity and supporting, functioning institutions to facilitate valuation and transfer of shares at the outset of the programme. However it remained premised on a neo-classical economic expectation that new, private owners would emerge to promote restructuring. The inconsistency of such a position has been revealed in this work by empirical evidence of restructuring in Czech enterprises

that shows ownership transfers alone are insufficient to promote the necessary restructuring changes. As a technical process, the privatisation programme centring on voucher privatisation was successfully structured to achieve the goal of rapid asset transfers. However, there are important institutional influences on the outcomes of privatisation that means the neo-classical economic foundation of voucher privatisation is inappropriate to predicting the resultant outcomes that will arise. It has been argued in this work that voucher privatisation does not take adequate account of the institutional environment in the Czech Republic into which it was to be applied, and that as a result the outcomes of privatisation are less favourable than the government expected.

Embedded institutionalism has been developed in this study as an alternative explanatory framework to neo-classical economics, where institutional influences are regarded as the determinants of observed outcomes, rather than market forces. Institutions are defined broadly in this approach, being understood to comprise formal, informal, and enforcement aspects. The inclusiveness aspect is complemented by the acceptance of a temporal dimension in the concepts of path-dependency and embeddedness. This means that the influence of the past is not assumed to decline in proportion to the passing of time, but that both the past and current periods may embody institutional influences that shape the contemporary outcomes. Also the underlying behaviour and therefore decision-making of agents involved in enterprise restructuring is modelled as that of *homo socio-economicus*, where economic as well as cultural institutions are accepted as potentially impacting on enterprise restructuring. The inclusion of all of these aspects of institutions in embedded institutionalism is important because they combine to eliminate any

predetermined judgement on the strength and validity of particular institutional influences.

Using embedded institutionalism in this study argues that observed restructuring outcomes in firms are shown to result from the interaction of various institutions that are unique to any given enterprise, and that these can only be fully understood with reference to this specific environment. This is in contrast to the unidirectional focus of neo-classical economic modelling of privatisation processes. This work has identified institutions that affect actual outcomes, and how their influence impacts on the subsequent restructuring. Responses obtained from interviews conducted in the case study firms have been used to illustrate how particular institutions within enterprises affect these outcomes. The crucial result derived from embedded institutionalism for assessing post-privatisation restructuring that distinguishes it from neo-classical economic perspectives concerns incentives. Embedded institutionalism, contrary to the frictionless markets premise of neo-classical economics, perceives that institutions are frictions that affect the specific restructuring that occurs, and the form this takes in privatised state-owned enterprises. In principle, voucher privatisation created many new owners of private property, but contrary to the predictions of neo-classical economics, the reality is that they often lack the associated control rights that need to be conferred if ownership is to be effective. Instead, those with authority within the firms to undertake or direct restructuring measures, which arises because they have the incentives to undertake such changes, are most significant to determine the restructuring that occurs. The implications of the divergence between *de facto* and *de jure* control as transpires in many firms after voucher privatisation for restructuring are discussed below.

7.2 *DE FACTO* CONTROL AND *DE JURE* OWNERSHIP.

Responses from the interviews conducted in the case study firms illustrate that there are institutional influences at work that generate outcomes other than those expected in accordance with neo-classical economics. Voucher privatisation did formally achieve the transfer of assets from state ownership and established some type of “popular capitalism”, but such political benefits have not been consistently matched by economic gains as a result of institutional influences. In particular it is argued that those with *de facto* control within enterprises are in a stronger position to initiate and conduct restructuring than those with *de jure* ownership. A particularly important problem is that the ownership patterns arising from voucher privatisation institutionalised difficulties with restructuring since

the expectation of privatisation was that whoever is the owning company or individual would become clear, and that they would take care of the company and either close it down or improve it. This is the principal aim in transferring property from state to private ownership. These expectations did occur, but only later. This is a matter of the method of privatisation. Personally I prefer the German method of privatisation with the principle of selling companies to individuals with finance. The Czech method was different and worse because was there was not this possibility here (Císar 4, Services Director).

This criticism was also endorsed by this respondent who argued that

privatisation for the company was meant to bring new customers, new markets, new finance etc but this did not occur. Voucher privatisation was just a “theatre for the people”. There should have had more change than occurred. After 1989 there were meant to be lots of small owners but this was a big mistake. Now even the government criticises privatisation. Privatisation was not for the Czech Republic but to make markets for foreigners. It would have been better if there had been a slower, step-by-step voucher privatisation programme without the immediate change from one owner to lots of smaller owners, where there are not really any owners. As such, all the small parts cannot succeed (Rukopis Strojírny 8, Quality Director).

As both respondents indicate, difficulties arise from voucher privatisation because of the lack of strategic owners with the resources to undertake restructuring. Dispersed ownership generates constraints against owners exercising control effectively, often resulting in incumbents gaining *de facto* control of privatised firms. Crucially, voucher privatisation has led to dispersed ownership that is enhanced by a weak ability amongst many shareholders to effectively exercise governance within firms, and dictates the restructuring that ensues. This means that even though solutions to the dispersal problem can be sought from consolidating share holdings, particularly through the involvement of IPFs and other institutional investors for Czech firms, many new owners are institutionally constrained from credibly exercising governance. They can lack the ability to do this because of limitations in finance, experience, and personnel. In other cases, cross-ownership and continued state-ownership of institutional investors are symptomatic of the lack of incentives facing new institutional owners to perform economically desirable restructuring because they

have conflicting interests. The extent to which the creation of new owners represents the emergence of an economically valuable private sector is therefore questionable. In the absence of an appropriate corporate governance system for Czech enterprises, often only quasi-private firms are emerging.

Problems arise largely because principal-agent problems are not always overcome within firms privatised by voucher. Limited experience and the persistence of disguised state-ownership in practice restrict the ability of new owners to undertake restructuring. Although owners may try to perform some restructuring, to fully understand the observed restructuring it is essential to also consider the actions of managers and employees as institutional influences. State ownership does not require governance to be formally specified, and so managers are ineffectually constrained by the principals in state-owned enterprises. This study maintains that this provides a strong institutional legacy on the behavioural patterns that transpire within state-owned enterprises following voucher privatisation. Incumbent managers will act rationally in their own interests, and in the absence of credible new owners, undertake to convert their former status within enterprises so that the *de facto* control attributed to them becomes the most important determinant of how restructuring occurs.

Managers are partially constrained in newly privatised enterprises, even where the new owners do not offer any credible discipline against them, because the economic environment has altered to become closer to that of a market economic system. In particular, with the move towards a hardening of budget constraints, persistently uneconomic performance in enterprises is not viable. Furthermore, managers have to be able to motivate the labour force to implement changes that bring efficiency gains

in production. With the demise of state socialism, the formal influence of labour representation within enterprises through the trade unions has declined, although the aggregate effect on the importance of labour's influence within enterprises is ambiguous. Developments in labour and industrial relations associated with transformation also support the pre-eminence of managers within restructuring firms because of a weakening of the formal position of labour in enterprises subsequent to privatisation. Although trade unions are included in national tripartite discussions, the decentralisation of social assistance away from enterprises has strongly constrained their traditional function in state-owned enterprises. Where unions have been unable or unwilling to redefine their role as has been seen widely in the Czech Republic, employee representation is usually of limited effect against managers and owners. Having attained primarily only formal representation within state-owned enterprises from the trade unions as instruments of the KSČ, this could be less important than it first appears, but the strength of labour resistance to restructuring measures that are detrimental to their position in enterprises has been negligible in the Czech transformation.

Even accounting for more rapid increases in recent years, unemployment levels recorded throughout the transformation period in the Czech Republic have been low, but this appears to have been at the cost of less restructuring than economically desirable for establishing a functioning market economy occurring in firms. These unemployment statistics offer another indication of the predominant influence of actors holding *de facto* control within firms, rather than shareholders with a direct economic interest in efficiency gains. To understand and appreciate fully the overall nature of restructuring within privatised Czech enterprises, reference again has to be

made to institutional influences. Favourable starting conditions for transformation in Czechoslovakia, in particular the highly centralised political and economic structures inherited from the period of central planning interacted with the liberalisation of labour and product markets to restrict the adverse effects of economic liberalisation on employment, at least until the mid-1990s. In addition, enterprises have retained much of their function as providers of social security assistance. This arises in combination because of a lack of complementary institutions and relative underdevelopment of legislation to provide social support away from the workplace, as well as expectations that remain for employers and employees over the type and extent of social provisions that should be extended to labour. This is seen in the persistence of labour hoarding, whether through excess labour use and maintaining low capital intensity of production, or by maintaining low wages that preclude the need for rationalising labour use within enterprises, causing low unemployment figures. Full employment was a political aim of the Communists that had the effect of institutionalising social protection within enterprises, but now employers can be unwilling to revoke this and employees to renounce the perceived rights they expect under the increasingly difficult and uncertain socio-economic environment of transformation.

This study has argued that the success of privatisation in promoting restructuring is determined by the extent to which institutions interact to challenge prevailing behaviours whilst also allowing an embedding of favourable changes within firms. In the Czech Republic, institutional influences mean that incongruence between neo-classical theory and the outcomes of privatisation exists. Although respondents

differed in their overall assessment of its benefits, there was widespread recognition that changes in the ownership of firms was necessary after 1989

because the state could not operate everything with what belonged to all belonging to no-one. Privatisation in general was inevitable, as the state could not operate these firms as it had done previously (Drazitest 1, Quality Director)

and similarly, "privatisation had to occur because at the time there was no other way to help the company and keep it alive" (Rukopis Strojírny 5, Assembly worker).

Of greater significance is the effectiveness of privatisation, with one respondent simply noting that "the decision to privatise was a good one but the question is whether the methods of privatisation were good" (Drazitest 1, Quality Director), and another commenting "certainly privatisation was good. It would have been better in other ways but it was necessary for the company. What will happen in the future cannot be predicted" (Rukopis Strojírny 2, Operations Director). For assessing privatisation, it is this future aspect that is most important, since the subsequent restructuring of firms is the desired objective of the programme.

From this study it has become apparent that the most enduring legacy of central planning, which also affects post-privatisation restructuring is that of retained mentalities, particularly deriving from expectations of state intervention in the public and private spheres. This is supported by the continued subordination of economics to socio-political concerns in the formal institutional environment. The interaction of institutions can therefore reinforce and encourage the persistence of institutions, but

formal structures do not have to be matched by concurrent changes in informal institutions, especially perceptions, and the enforcement aspect of institutions.

7.3 INSTITUTIONAL PERSISTENCE.

Although several respondents claimed there are “no legacies of the past” in the current operation of their companies (Rukopis Strojírny 1, Personnel Manager; Rozdat Systems 6, Supervisor; Drazitest 4, Researcher), this work has shown that in understanding the restructuring outcomes in firms, such a position is untenable. As the discussion in preceding chapters has shown, institutional influences are path-dependent and embedded. In addition to the institutional environment within which firms operate, there are real legacies from the past that persist into the present and influence the current outcomes of privatisation and restructuring, and therefore can also be expected to continue in the future. Regardless of whether these are accepted by actors within the firms, this study has shown that it is these legacies that prevent the privatisation process operating as expected when it was originally conceived along neo-classical economic lines.

Throughout the preceding chapters, the interview responses have indicated that rather than changes made to formal institutions, it is informal institutions that are most influential in determining the precise nature of measures adopted, and the consequent restructuring outcomes after privatisation. In this section, a number of responses from the case study interviews are used to illustrate instances of restructuring and the perceptions of respondents that demonstrate this conclusion. Highlighted as the main constraint on change is learned behaviour and mentalities that means “privatisation

was hard and still is because of a “generational problem”. People were not prepared for such a change as occurred” (Rukopis Strojírny 2, Operations Director), as “the period before 1989 was too long. In 1989 people were not ready to change with these events as people saw everything as common goods” (Rozdat Systems 2, Production Manager). Other respondents commented that factors enhancing this reluctance to change were that the “legacies of communism are not easily erased” (Brodchmel 4, Quality Manager), causing a “slow pace of learning after 50 years of certain moral and political principles. We cannot make all the necessary changes in a short period of time because of a mentality problem” (Drazitest 1, Quality Director).

In Rukopis Strojírny on respondent explicitly recognised this institutional constraint, commenting that

technically the factory continues as normal. The machinery is fine but the main problem is with peoples’ mentality and how to make products that people actually want as previously they were just passed onto a state company to be sold, but this is a problem common to all private firms (Rukopis Strojírny 8, Quality Director).

A director in another firm held a similar perspective, and spoke of how

some of the activities here are the same as before. Certainly there are legacies from the past as the mentality of people is hard to change. It is a pity that the changes in 1945 occurred. It would have been better if privatisation was not needed at all because to introduce this so that it is fair to everyone and based on

good economic principles is actually impossible to do (Drazitest 6, Business Director).

In the absence of credible new institutions it is hard to change existing behavioural patterns, which can make restructuring more difficult. One respondent believed that inconsistencies in the legislation hindered feasible structural improvements throughout the economy, since

privatisation could lead to restructuring but it needs appropriate legislation such as laws to make starting up large enterprises easier. The conditions for starting new businesses are more discriminative than helpful. Coming from a Communist background, people do not have experience with other firms in Western states. If there were no holes in the legislation it would have been better (Drazitest 2, Production Director).

Others admitted that the legislation is not credible, so that “there are laws relating to the company, but if these are not strictly demanded then they are not really obeyed” (Přesnost KM 4, Financial Director). One firm had direct experience of such problems because

many companies in the market do not offer an honest service and we have to deal with companies that offer bribes. If you try to be honest it is difficult but without orders, the company is not profitable (Drazitest 4, Researcher).

However, a positive aspect arose in this case with the company moving to a more consumer-oriented position so that it “doesn’t need to bribe companies for orders but just offer more services for the money charged on a project” (Drazitest 4, Researcher) to maintain its market position.

Whilst path-dependency and embeddedness are real and important constraints on the actual changes that occur, their impact is neither deterministic nor unidirectional. Rather, it is necessary to appreciate that both potentially influence restructuring in any firm since

the past always influences the future situation. I have to say that there are not just negatives from the past but also positives extracted from the past that are the foundations for future developments. Generally it can be said that what is important or really matters is to take the positive aspects and to distinguish from the negatives and to use the positive aspects in the future (Císař 4, Services Director).

Of particular importance is that difficulties in the transformation are not seen as inevitable because of institutional influences and legacies. The expectations generated under Communism influence the perception of what changes are necessary and how these can be accomplished. This created some positive aspects as

some people even before 1989 expected change and did not believe in communism. They began working hard and caring about their jobs more, and tried to improve and grow professionally. Others didn’t care about

privatisation, and didn't think about the future or attempt to change and grow. Some gave 100% even before privatisation and would work overtime because they really cared about their job. People had to personally decide whether to use the time even under communism productively at a personal level. Some people did not want to grow during communism and were getting good money, while others did use their time in a productive way even though they did not get paid for it. Deep in the older generation's mind are the capitalist principles of before 1948. Successful people have used them since 1989 when they just "woke up" as if this was "in their genes". Communism was too short a time to forget these principles (Drazitest 4, Researcher).

Nevertheless, the effect of past experiences affecting mentalities is that there are constraints on introducing even desirable changes. One respondent summarised the effects of this, saying that

in 1989 it was obvious that the Czech Republic was on the border between East and West. A picture of Czech industry is of a chained dog set free but it is not very well developed and so will go back to what it knows from before. Voucher privatisation can be compared to the social revolution and nationalisation of property as seen in 1948 (Rozdat Systems 1, Managing Director).

Not only is there a persistence of institutions, but this respondent recognised the institutional similarities between the widespread, but state-driven, nationalisation of the Communists and voucher privatisation. This indicates that there could be an expectation already engendered within the population of the impact of a widespread

change in property ownership from such historical precedents. In conclusion therefore, this final section mobilises embedded institutionalism to consider the issue of distinct Czech aspects of the privatisation and restructuring processes observed in former state-owned enterprises privatised by voucher.

7.4 IS THERE A “CZECH WAY”?

Principally with reference to the voucher privatisation scheme that stresses the involvement of domestic financial institutions and capital, some commentators have referred to the way in which privatisation in Czechoslovakia and the Czech Republic has been conducted as the “Czech way”.³ In this study it is argued that what is “Czech” about the privatisation process does not concern the design of the programme, but the nature of restructuring responses in enterprises that the transfer of property rights was supposed to promote, and how this has occurred under the actually prevailing conditions. The diversity of restructuring choices taken in privatising enterprises suggests that rather than there being *the* “Czech way”, enterprises and actors involved in restructuring simply respond to the numerous institutional influences that provide the specific institutional context for each enterprise.

This study has demonstrated that institutional influences cannot be ignored if observable privatisation and restructuring outcomes are to be understood.

³ See for example Václav Klaus, *Česká Cesta* (Praha: Profile, 1994); Michal Dlouhý, ‘Czech Privatization: A Ten-Year Overview’ *Privatisation International*, 140 (2000), 26-27. 9 November 2000. <http://www.whitecase.com/memo_czech_privatization_dlouhy.html>, [n.p.]; Quentin Reed, *Corruption in Czech Privatisation: Dangers and Policy Implications of Neo-liberal Privatisation*,

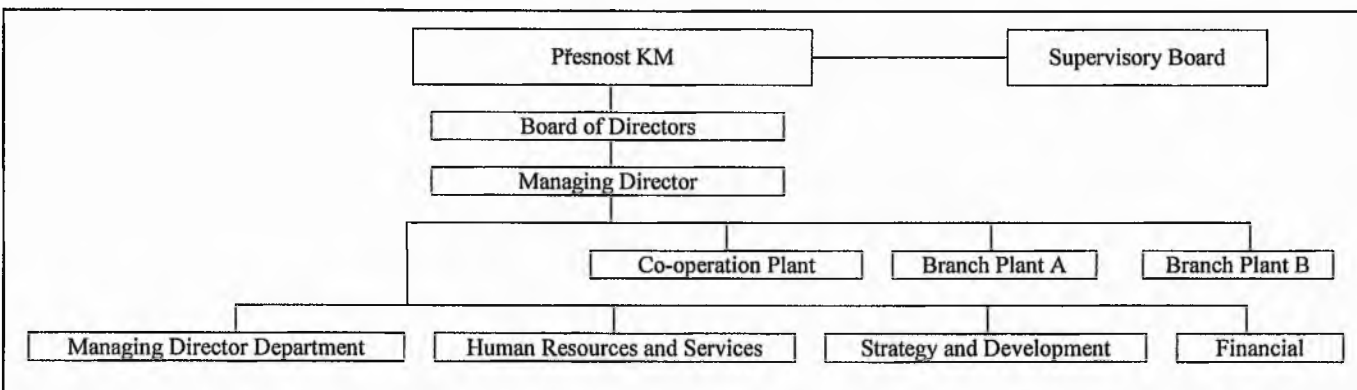
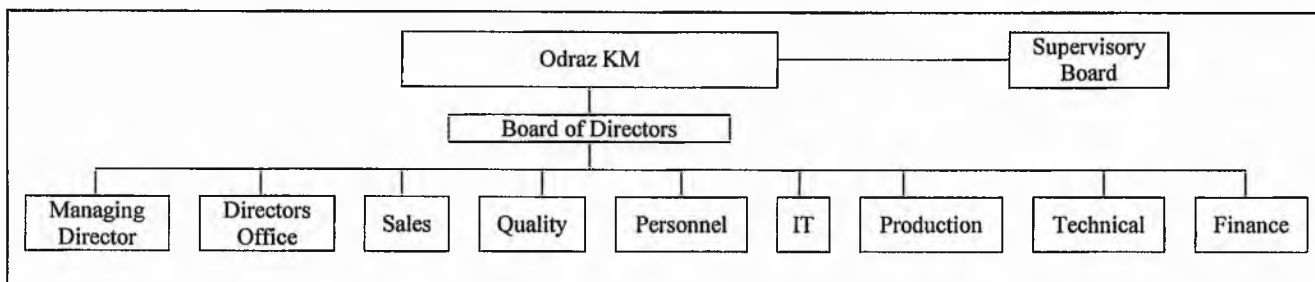
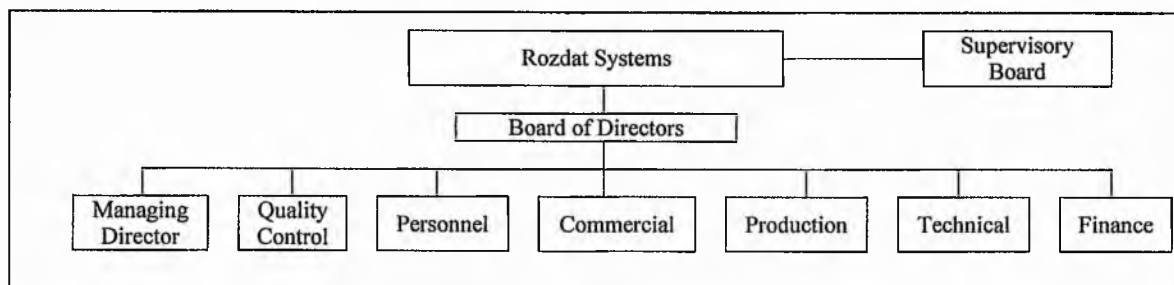
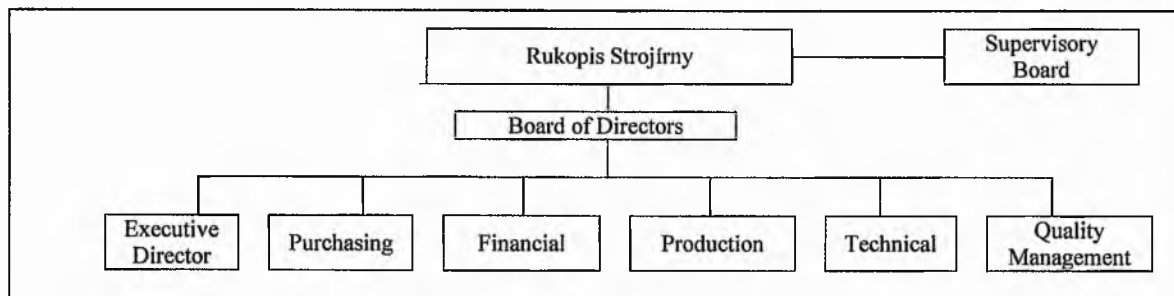
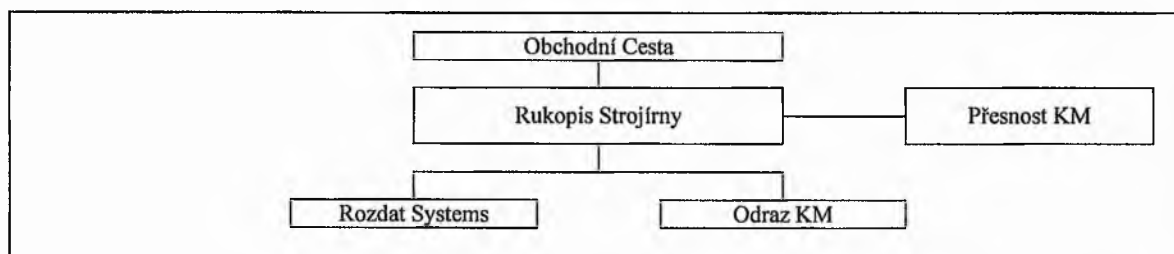
Methodologically, the use of neo-classical economic theory in modelling the effects of privatisation on restructuring is invalidated in transformational economies. In this work, preference is given to the embedded institutionalism approach as being a more appropriate framework, with the implication that this is the way in which observed responses in enterprises should be perceived and understood in other transformational economies. However, comparable outcomes within firms will not necessarily be replicated in other firms, and even less outside of the country, because privatisation and restructuring outcomes arise in response to a firm's unique institutional environment.

Conceptualising privatisation and subsequent restructuring through embedded institutionalism indicates that a definable Czech paradigm does not exist. Instead, an evaluation of privatisation and restructuring processes and their outcomes in all transformation economies from the standpoint of embedded institutionalism demonstrates that these are a reflection of institutional interactions between enterprises and their own environments. Each restructuring outcome reflects a path-dependent and embedded response to formal and informal institutions. This ensures that even if observed outcomes are not consistent with the projections of neo-classical economic theory, they can still be understood as rational responses to their context.

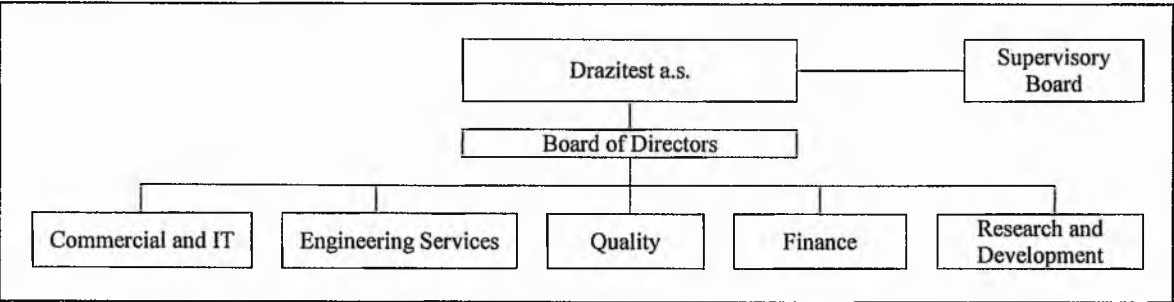
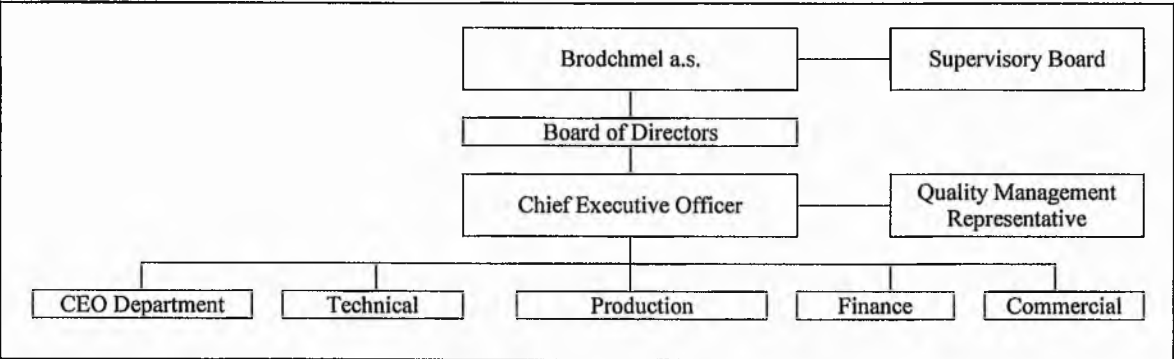
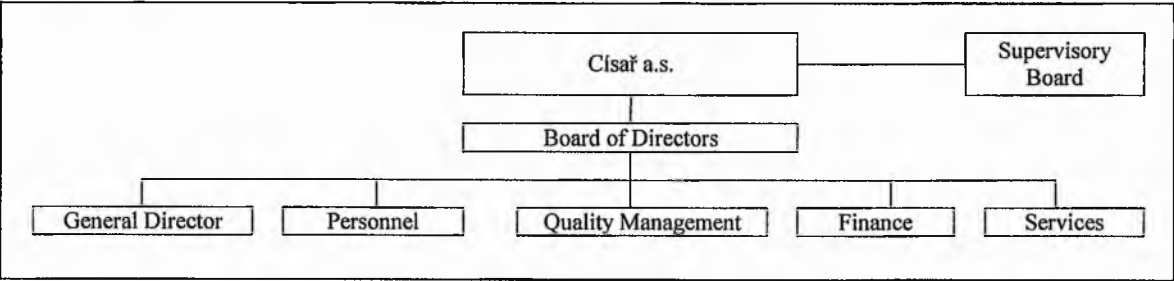
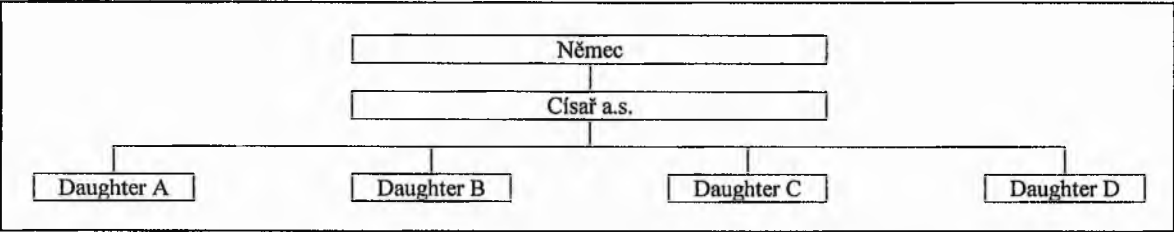
This thesis therefore concludes that the post-privatisation restructuring visible in companies are the particular, observable patterns of restructuring it has adopted in response to the historical and contemporary institutional environment within which is it situated. In considering institutional influences, this study has shown that there are

a number of legacies and myths for the Czechs to draw upon and generate their own response to privatisation, ranging from the pre-Communist era, the distinct phases of Communist rule, especially normalisation, and the country's extrication from Communist rule and the resultant path of post-communist development. There is a persistence of institutional influences that has a temporal dimension, and a primacy of control over ownership that determines the influence of different actors on the restructuring outcomes that arise. The inference that rather than there being a "Czech way" of privatisation and restructuring, and by extension, transformation, but instead standard socio-economic responses to the prevailing institutional environment was confirmed by this director. Referred to the way in which his company endeavours to "take positive aspects from dealing with foreign clients and put this with the Czech way of dealing with and solving things" (Císař 4, Services Director), essentially summarised the Czech approach to post-privatisation restructuring in companies by observing that "we belong to Europe and can bring our own "Czech" solution".

APPENDIX 1: OBCHODNÍ CESTA GROUP COMPANY STRUCTURES



APPENDIX 2: CÍSAŘ, BRODCHMEL AND DRAZITEST COMPANY STRUCTURES



APPENDIX 3: CASE STUDY METHODOLOGY

Identifying institutional pressures that work to determine enterprise restructuring choices and their impact on privatisation and restructuring is integral to the appropriateness of embedded institutionalism as an explanatory framework in this study. Interviews were conducted to determine how respondents perceive aspects of the privatisation and subsequent enterprise restructuring processes, in particular their impressions of restructuring decisions taken, and the motivation or constraints on these changes. The responses are used to discern institutional processes and how these have influenced restructuring choices for privatising firms in the Czech Republic. Although the design of the voucher privatisation scheme was motivated by neo-classical economic theory with expectations of efficiency gains and subsequent owner-driven restructuring, such outcomes have not arisen, and this thesis attempts to understand why.

A research schedule comprising core questions for the interviews was constructed to ascertain how theoretical predictions contrast with the experience within privatising enterprises, in order to try and understand institutional influences that produce the actually observed outcomes. The topics covered included:

- the respondents' overall experiences and impression of privatisation in Czechoslovakia and the Czech Republic generally, and specifically in their company;
- changes in managerial and ownership functions and tasks;

- industrial relations issues, particularly relating and to employment, wages and trade unions; and
- structural adaptations of the enterprises to privatisation.

The interviews were semi-structured in format, each beginning with a discussion of the respondent's background and personal experience with privatisation. In every case, the topics outlined above were then discussed, but the actual content and direction of the interview depended upon the respondent's experience, knowledge and willingness to discuss particular issues. Respondents were encouraged to consider the situation in their company or function before and after privatisation, and to provide comparative assessments in their interpretations and impressions. All of the questions were phrased in an open-ended format, with additional questions asked where comments needed further clarification, or if the responses prompted discussions on enterprise-specific situations that were not covered by the question schedule. A native Czech speaker translated the interviews in most cases. As well as avoiding linguistic barriers, discussing the interviews afterwards allowed for aspects of non-verbal communication and cultural and behavioural nuances to be understood and accounted for in interpreting the responses.

Within each company, respondents comprised a cross-section of directors, managers, and workers. This was arranged in order to obtain a wide range of responses that could illustrate different facets and interpretations of the processes and contemporary outcomes of privatisation and restructuring. Directors and top managers were interviewed because they are directly involved in decision-making. Workers were also included because their perspective on the decisions taken and the effects within

the firm is useful in determining the extent to which these decisions were communicated to and implemented within the firm, and practical difficulties to achieving this. For each company approached to participate in the study, this justification for a cross-section of employees to be interviewed was given, and the details of key respondents were made part of the agreed conditions of access.

Although there is an implicit subjectivity in the comments and interpretations of the complex, multidimensional reality of restructuring processes, this is not seen as a limiting factor in extrapolating from the comments to ascertain institutional pressures acting on enterprises. Using the same topics with each respondent, and sampling employees across age and function compensates for differences in the depth of coverage in each interview by permitting additional reinforcement and validation of responses within companies. Embedded institutionalism aims to account for a range of institutions and their different dimensions. A range of interpretations of their formal and informal expression and impact as provided by the interviews is thus essential to this approach.

To ensure an appropriate sample of respondents, it was requested that potential respondents were of different ages, with a variety of educational backgrounds and length of service within the company, and representing different functions within the company. Table A.1 summarises the respondents in each firm used in the study according to these characteristics.

Table A.1: Summary of Respondents.

Interview:	Rukopis Strojiny	Rozdat Systems	Odráz KM	Přesnost KM	Drazitest	Císař	Brodchme
1	Personnel Director Mid 50s Secondary education, entire career in group.	Managing Director Mid 50s Secondary education, entire career in group.	Managing Director Late 50s Apprentice in Přesnost KM, entire career in group.	Financial Planning Manager Late 30s. Secondary education, entire career in group.	Quality Director Late 50s University education, most of career in Drazitest.	Trade Union President Mid 60s University education, started in company in 1959.	Personnel Manager Early 50s Secondary education, entire career in company
2	Operations Director Early 40s University education, entire career in group.	Production Manager Late 50s Secondary education, entire career in group.	Marketing Manager Mid 40s University education, entire career in group.	Co-operation Plant Section Manager. Early 30s. Secondary education, entire career in group.	Production Director. (Vice President Board of Directors) Mid 50s University education, entire career in company.	Machine worker. (Department trade union Chairman). Late 50s Company apprentice, entire career in company.	Project Manager Late 40s. Secondary education, entire career in company
3	Mechanic Late 50s Secondary education, entire career in company.	Maintenance Department supervisor Mid 30s Secondary education, entire career in company.	Technical Designer Mid 20s University education, started in company in 1998.	Assembly line worker. (Trade union representative.) Early 50s. Company apprentice, entire career in group.	Supplies Manager Late 40s. Secondary education, entire career in company.	Retired Analyst Early 60s. University education, entire career in company.	Assembly Section Head Mid 50s. Secondary education, entire career in company
4	Machine worker Early 50s Company apprentice, entire career in company	Technical Director Early 40s University education, entire career in group	Secretary Late 30s Secondary education, started in company in 1997.	Financial Director Mid 40s. University education, entire career in group.	Researcher Mid 60s. University education, entire career in company.	Services Director Early 40s. University education, entire career in company.	Quality Manager Late 30s. University education, entire career in company
5	Assembly worker Late 40s Secondary education, entire career in company.	Financial Director Late 30s Secondary education, started 1994	-	-	IT Analyst Early 40s University education, entire career in company.	-	-
6	Machine worker Late 40s Secondary education, entire career in company.	Supervisor Mid 40s Company apprentice, entire career in company.	-	-	Business Director. (President Board of Directors) Mid 40s. University education, entire career in company.	-	-
7	Foundry worker Early 20s Secondary education, company apprentice.	Supervisor. (Departmental Trade Union Chairman) Mid 40s Company apprentice, entire career in company.	-	-	Personnel Manager Early 40s Secondary education, started in company in 1994.	-	-
8	Quality Director Early 50s University education, started in company in 1997.	-	-	-	-	-	-
Directors	3	3	1	1	3	1	0
Managers	0	1	1	2	2	0	3
Workers	5	3	2	1	2	3	1
Total	8	7	4	4	7	4	4

The number of respondents interviewed varied between firms, depending upon their willingness to participate and the availability of personnel, with some interviews having to be conducted outside of working hours. In most firms, selected respondents were dictated by the company, but in Císař and Brodchmel the top management would not directly arrange and thereby endorse the participation of any employees in these interviews, although they agreed to interviews being undertaken. In these cases, contacts had to be established with each respondent directly.

Whilst not permitting direct comparisons between the cases, the considerable variations in the characteristics of participants across the firms is not seen as a problem with the methodology for this work. The responses from the interviews reflect the perspectives of enterprise insiders and their interpretations of the processes that resulted in the restructuring outcomes that are visible in privatised enterprises. The wide range of respondents, with unique perspectives, especially in relation to their position within the company and integration with the institutions that define the feasible range of choices makes them valuable in identifying and assessing institutional pressures facing restructuring enterprises. This facilitates a balanced assessment of institutional influences on enterprise restructuring in the case study firms through embedded institutionalism.

APPENDIX 4: KEY PRIVATISATION LAWS.

Act 103/1990 Zákon, Kterým se Mění a Doplnuje Hospodářský Zákoník.

Act 111/1990 Zákon o Státním Podniku.

Act 298/1990 Zákon o Úpravě Některých Majetkových Vztahů Řeholních Řádů a Kongregací a Arcibiskupství Olomouckého.

Act 403/1990 Zákon o Zmírnění Následků Některých Majetkových Křivd.

Act 427/1990 Zákon o Převodech Vlastnictví Státu k Některým Věcem Na Jiné Právnícké Nebo Fyzické Osoby.

Act 458/1990 Zákon, Kterým se Doplnuje Zákon 403/1990, o Zmírnění Následků Některých Majetkových Křivd.

Act 500/1990 Zákon České Národní Rady o Působnosti Orgánů České Republiky ve Věcech Převodů Vlastnictví Státu k Některým Věcem Na Jiné Právnícké Nebo Fyzické Osoby.

Act 87/1991 Zákon o Mimosoudních Rehabilitacích.

Act 92/1991 Zákon o Podmínkách Převodu Majetku Státu Na Jiné Osoby.

Act 229/1991 *Zákon o Úpravě Vlastnických Vztahů k Půdě a Jinému Zemědělskému Majetku.*

Act 513/1991 *Obchodní Zákoník.*

Act 248/1992 *Zákon o Investičních Společnostech a Investičních Fondech.*

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